

## Tax Audits as Scarecrows: Evidence from a Large-Scale Field Experiment<sup>†</sup>

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*The canonical model of Allingham and Sandmo (1972) predicts that firms evade taxes by optimally trading off between the costs and benefits of evasion. However, there is no direct evidence that firms react to audits in this way. We conducted a large-scale field experiment in collaboration with a tax authority to address this question. We sent letters to 20,440 small- and medium-sized firms that collectively paid more than US\$200 million in taxes per year. We find that providing information about audits significantly affected tax compliance but in a manner that was inconsistent with Allingham and Sandmo (1972). (JEL C93, D22, H25, H26, K34, L25, O14)*

Tax audits are a standard tool that most tax administrations have used throughout history. Audits increase tax revenues directly because firms caught evading must pay taxes on the hidden income as well as penalties. Except in the case of large taxpayers, however, these direct revenues are not enough to make audits cost-effective. Audits play a central role in the deterrence paradigm of tax evasion: the threat of being audited in the future—of being caught evading and having to pay penalties—deters firms from evading taxes in the present.

Audits may be useful to fostering tax compliance, but there is no direct evidence on how firms react to them. The Allingham and Sandmo (1972) model—henceforth, AS—is the canonical model of tax evasion in economics. It is an application of Becker (1968), in which selfish individuals choose whether to engage in criminal

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activities by calculating expected costs and benefits. In AS, firms choose the optimal amount of income to hide from the tax authority so that the marginal benefits (i.e., the lower tax burden) equal the marginal costs (i.e., the penalties they will be required to pay if caught). This intuition is so deeply ingrained in economic thought that most economists take it for granted. Be that as it may, surprisingly little causal evidence exists on whether real firms react to audits in this profit-maximizing fashion (Alm, McClelland, and Schulze 1992; Luttmer and Singhal 2014; Slemrod 2019). In this study we provide direct tests of the AS model based on a high-stakes, large-scale field experiment.

We study small and medium-sized firms in Uruguay that are subject to the Value-Added Tax (VAT). Though that is a context in which taxpayers should care about the threat of being audited, that is not always the case: tax agencies can sometimes use third-party reporting to automatically detect and rectify tax evasion regardless of whether the taxpayer is audited, thus making the audit threat irrelevant. For instance, the US Internal Revenue Service uses their electronic records to compare the wage amount reported by an individual to the amount reported by the individual's employer. This algorithm automatically rectifies the discrepancies in reporting and sends a notification to the taxpayer with the updated tax amount to be paid. Because the evasion will be caught through the third-party reporting regardless of whether the individual is audited, taxpayers should not care about the threat of being audited (Kleven et al. 2011). On the contrary, in our context of the VAT in a developing country, such automatic cross-checking and rectification does not exist. The VAT paper trail, which consists of nonelectronic invoices, can only be scrutinized in the event of an audit.<sup>1</sup> Thus, tax authorities must rely heavily on the threat of audits to discourage VAT evasion (Gómez Sabaini and Jiménez 2012; Bergman and Nevarez 2006).

We collaborated with Uruguay's Internal Revenue Service (hereafter referred to as IRS) to conduct a natural field experiment with a sample of 20,440 small and medium-sized firms subject to the VAT. For our study, the IRS mailed four different types of letters with information on audits to the owners of each of these firms.<sup>2</sup> Some of the information contained in each of these letters was randomized, with the goal of testing predictions of AS. Using IRS administrative records, we measured the effects of the information contained in the letters on the firms' subsequent compliance with the VAT and other tax liabilities. Additionally, we collaborated with the IRS to conduct a postmailing survey to capture the effect of this information on these firms' subsequent perceptions of audits.

Following the seminal work by Slemrod, Blumenthal, and Christian (2001), the first part of the experimental design measures how informing taxpayers of tax enforcement affects compliance. Firms were randomized into four different letter types: baseline, audit-statistics, audit-endogeneity, and public-goods. The baseline

<sup>1</sup> While the VAT requires a paper trail, which is a form of third-party reporting, that paper trail is subject to significant limitations, chief among them the fact that there is no simple algorithm that automatically detects tax evasion. Moreover, the paper trail breaks down when it reaches the consumer (Naritomi 2019). Finally, firms can also collude to tamper with the paper trail (Pomeranz 2015).

<sup>2</sup> Throughout this paper, for simplicity's sake, we refer to firms' perceptions and behavior as a shorthand for the perception and behavior of the firms' owners or managers.

letter type included brief and generic tax information that the IRS often includes in its communications with firms. The audit-statistics letter type was identical to the baseline letter but contained as well information on the probability of being audited and the penalty rate according to tax administration statistics. The hypothesis is that adding the audit-statistics message to the baseline letter will deter tax evasion; that is, it will increase posttreatment tax payment. We can compare the effects of this audit-statistics message with the effects of other types of messages. The audit-endogeneity letter type provided information on a different feature of the auditing process. It was identical to the baseline letter except for the inclusion of an additional message on how evading taxes increases the probability of being audited. The public-goods letter type was designed as a benchmark message that might increase tax compliance without providing information on tax audits. It was identical to the baseline letter, except for the inclusion of an additional message describing the social costs of evasion by detailing the set of public goods that could be provided if tax evasion were lower.

We show that, consistent with Slemrod, Blumenthal, and Christian (2001) and the subsequent literature, informing firms of tax enforcement increases compliance. We find that adding the audit-statistics message to the baseline letter increases tax payments by about 7.0 percent in the first posttreatment year; the effects continue into the second posttreatment year but are only half as large and no longer statistically significant. This effect is economically significant: the estimated average VAT evasion rate in Uruguay is 26 percent (Gómez Sabaini and Jiménez 2012). While the tax base is not necessarily fully comparable, this figure implies that the 7.0 percent increase equals a 27 percent reduction in VAT evasion. The effect of the audit-statistics message (increased tax payments of 7.0 percent in the first year) is similar in magnitude to the effect of the other message on tax audits (7.1 percent, for audit-endogeneity) but larger and more persistent than the effect of the public-goods message (5.1 percent in the first year but negligible in the second year).

The second and most important part of the experimental design tests the hypothesis that firms react to information about audits as predicted by AS. We provide two tests of AS. The first test exploits survey data on perceptions of audits. If the audit-statistics letter had a positive effect on average tax compliance, for this effect to be consistent with AS, it must be true that the letter increased the average perceived probability of being audited or the perceived penalty rate. To test this hypothesis, we designed a survey, which was sent out months after the firms received the audit-statistics and audit-endogeneity letters, eliciting perceptions of the probability of being audited and the penalty rate.

The second test of AS is based on heterogeneity in the signals induced by the letters. We included exogenous, nondeceptive variation in the information on audit probabilities and penalty rates in the audit-statistics letter. To generate this information, we computed the average probabilities and penalty rates using a series of random samples of fifty firms. This sample size was small enough to introduce nontrivial sampling variation in the average probabilities and fines shown to the subjects. Specifically, a given firm could receive a letter saying that the audit probability is 8 percent, 10 percent, or 15 percent, depending on the sample of similar firms chosen for that particular letter. These random variations in probabilities and

penalties allow us to test whether firms evade less when they face higher audit probabilities and higher penalty rates, as predicted by AS.

The second part of the results suggests that the effects of the audit-statistics letter are not consistent with AS. Based on the survey data, the results for the first test indicate that the audit-statistics message reduced the perceived probability of being audited, which, according to AS, would in turn reduce compliance. We find, however, that the audit-statistics message actually increased average compliance.

The second test shows that, contrary to the AS prediction, signals of audit probability and penalty rates in the audit-statistics message had no differential effect on compliance. The estimated elasticity of tax compliance with respect to audit probabilities and penalty rates is close to zero and precisely estimated. Moreover, we compare our experimental estimates to the results from calibrations of AS. We reject the null hypothesis of AS even under conservative assumptions about how much firms learned from the audit-statistics message. These results suggest the presence of probability neglect, i.e., that firms react similarly to the threat of being audited regardless of its actual probability or the penalties involved.

As a complement to the audit-statistics treatment arm, we designed a separate treatment arm that created exogenous variation in expected audit probabilities in a more direct way. The audit-threat letter type was sent to a separate sample of firms that were preselected by the IRS for auditing. We randomly divided this set of firms into two groups, one with a 25 percent probability of being audited and the other with a 50 percent probability. The audit-threat letter informed firms of the exact audit probability that was assigned to them. Consistent with the audit-statistics treatment arm, we find probability neglect in the audit-threat arm too.

In sum, we find that informing firms of tax audits increased their tax compliance, but the reaction to the information was inconsistent with the optimal reaction predicted by AS. On average, firms reduced, rather than increased, their perceived probability of being audited. Furthermore, reaction was not heightened when firms were faced with a higher probability of being audited or a higher penalty rate. These results suggest that while firms may comply with tax obligations because of the threat of audit, their response is not necessarily optimal as in AS.

Hence, the question arises as to which alternative model best explains the firms' reactions to audits. Models of salience (Chetty, Looney, and Kroft 2009) and prospect theory (Kahneman and Tversky 1979) can explain some, but not all, findings. As highlighted in recent models of firm evasion (Kleven, Kreiner, and Saez 2016), agency issues within firms could play a role, but they cannot explain our findings either. Our preferred interpretation is based on the model of risk-as-feelings (Loewenstein et al. 2001). The models used for choice under risk are typically cognitive: people make decisions using some type of expectation-based calculus. The risk-as-feelings model proposes that responses to fearsome situations may differ substantially from cognitive evaluations of the same risks. When fear is involved, responses to risks are quick, automatic, and intuitive and thus neglect the underlying probabilities (Sunstein 2003; Sunstein and Zeckhauser 2010). The model of risk-as-feelings can reconcile all of our key findings. Moreover, we present anecdotal and survey evidence indicating that fear of being audited does indeed play a significant role in tax compliance. We also discuss policy implications for increasing tax capacity.

Our study relates to various strands of literature. First, it forms part of a recent but growing body of literature that uses field experiments in partnership with tax authorities to study the decisions of individuals to pay taxes. In a seminal contribution Slemrod, Blumenthal, and Christian (2001) showed that, for a sample of US self-employed individuals, those who were randomly assigned to receive a letter from the Minnesota Department of Revenue with an enforcement message reported higher income in their tax returns than those who received no letter. Similar messages about tax enforcement have been shown to have positive effects on tax compliance in other contexts (for recent reviews, see Pomeranz and Vila-Belda 2019; Slemrod 2019; Alm 2019).<sup>3</sup> One common interpretation in this literature is that taxpayers react to information on tax enforcement tools and, in line with AS, reduce their evasion to reoptimize their behavior. There is no direct evidence in favor of or against this interpretation, however. We hope to contribute by filling this gap in the literature.

This paper is closely related to a group of studies testing AS predictions in a laboratory setting. For example, Alm, Jackson, and McKee (1992) conducted a laboratory experiment in which undergraduate students play a tax evasion game. Subjects can hide income from the experimenter, but some subjects are randomly selected to be audited and must pay a penalty if they are caught evading. The authors show that, in the game, tax compliance increases significantly with audit and penalty rates, but these effects are economically small, indeed smaller than the effects predicted by optimizing behavior in the context of AS. The laboratory experiment setting of Alm, Jackson, and McKee (1992) and similar studies have a number of advantages, such as full control over the rules of the game and freedom to select parameters. These laboratory experiments have two main limitations, however. First, the subjects are typically undergraduate students playing the tax game for the first time, with no real-world experience of paying taxes. In contrast, subjects in our field experiment are experienced firm owners who have been registered with the tax agency, that is, paying taxes, for an average of 15 years. Second, subjects in the laboratory games typically pay less than US\$10 in tax. In contrast, subjects in our field experiment paid US\$11,800 per year in taxes (to get a sense of this magnitude, Uruguay's GDP per capita in 2015 was around US\$15,000).<sup>4</sup> We contribute to this literature in two ways. We show that AS does not fare substantially better in a natural context with experienced subjects and high stakes. Additionally, we show that audit threats can still be useful to reduce evasion even if taxpayers don't react to audits optimally.

Our findings also contribute to the more general debate about the determinants of tax compliance. The literature wonders why, among smaller firms and self-employed individuals in particular, evasion rates are so low, given the low detection probabilities and penalty rates (Luttmer and Singhal 2014). One traditional explanation is tax morale: firms and individuals do not evade taxes because they feel morally obliged to comply (Luttmer and Singhal 2014). Our evidence

<sup>3</sup>For example, Slemrod, Blumenthal, and Christian (2001); Kleven et al. (2011); Fellner, Sausgruber, and Traxler (2013); Pomeranz (2015); Castro and Scartascini (2015); Dwenger et al. (2016); Perez-Truglia and Troiano (2018).

<sup>4</sup>In the 12 months before our experiment, the firms in our sample paid an average of US\$7,770 in VAT and US\$4,070 in other taxes; the GDP per capita in Uruguay was about US\$15,000 in 2015.

suggests an alternative explanation: taxpayers overreact to the threat of audits because their tax decisions are emotional. In other words, audits scare taxpayers into declaring their income truthfully just like scarecrows scare birds away. This would explain why, despite low audit probabilities and penalty rates, most taxpayers still report the threat of audit as a major reason why they don't want to evade taxes (United States Internal Revenue Service 2017).

The paper is organized as follows. Section I discusses the experimental design. Section II presents the data sources and discusses the implementation of the field experiment. Section III presents the results on the average effect of the audit-statistics message. Section IV presents the two tests of AS. Section V discusses the interpretation of the findings. The final section concludes.

## I. Experimental Design

Our experiment consisted of a mail campaign sent out by Uruguay's IRS with multiple treatment arms and subtreatments. Rather than comparing firms that received a letter to firms that did not, all of our analyses are based on comparisons between firms that received letters with subtle variations in content. We can thus control for the potential effects on compliance of simply receiving a letter from the tax authority, even if the letter is just a reminder to report taxable income.

The letters consisted of a single sheet of official IRS letterhead with the name of the recipient in the header and the scanned signature of the IRS General Director at the bottom. These letters were folded, sealed in an official IRS envelope, and sent by certified mail to guarantee direct delivery to the recipient and signature upon receipt. Panel A of Figure 1 shows the sample sizes for the different treatment arms detailed below.

### A. Baseline Letter

The baseline letter contained information on the goals and responsibilities of the tax authority routinely included in IRS communications with firms. It explained that the individual had been randomly selected to receive this information, that the letter was for informational purposes only, and that there was no need to reply or to provide any documentation to the IRS. Figure 2 provides a sample of the baseline letter, with the addition of a placeholder box with the word "MESSAGE" written inside.<sup>5</sup> This box was empty in the baseline letter but contained a different message (printed in larger print and boldface) in each of the other letter types.

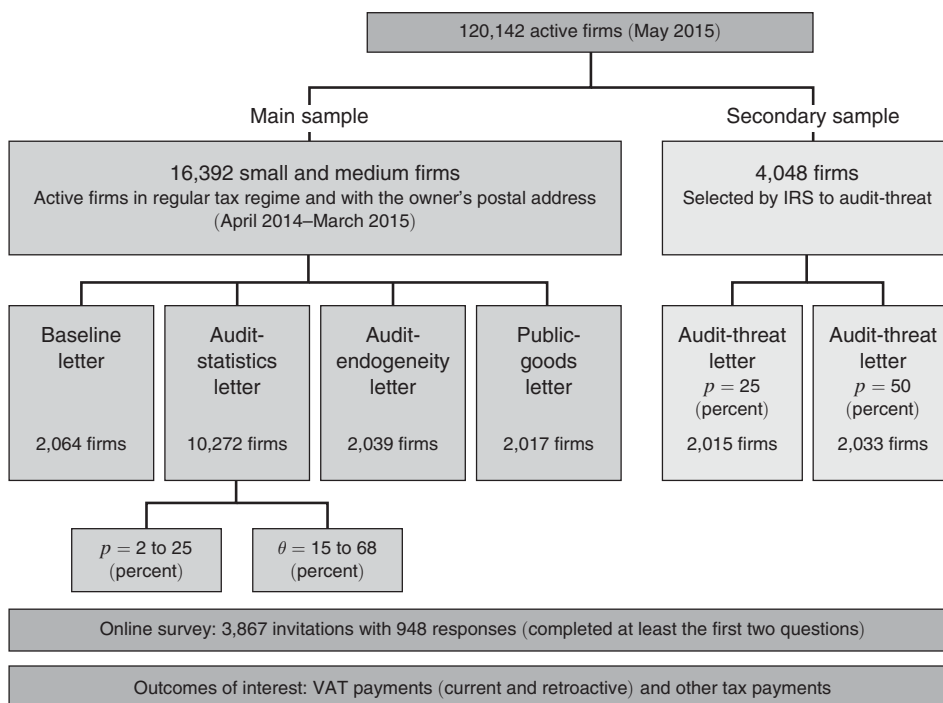
### B. Audit-Statistics Letter

According to the Allingham and Sandmo (1972) model, we expect risk-averse firms to be interested in information on the audit process because it helps them

<sup>5</sup>For a full-page sample of the letter without this placeholder, see online Appendix A.1. For the corresponding samples of the audit-statistics, audit-threat, audit-endogeneity, and public-goods letter types, see online Appendixes A.2, A.3, A.4, and A.5, respectively.



Panel A. Samples and treatment arms



Panel B. Timeline

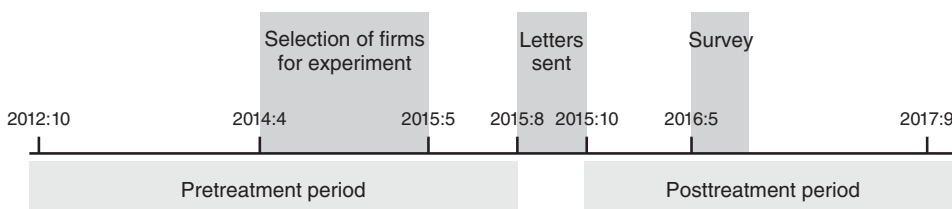


FIGURE 1. STRUCTURE OF THE FIELD EXPERIMENT

Notes: Panel A reports the key features of the experimental design. Panel B reports the key dates of the field experiment and the survey.

optimize their tax-payment decisions and potentially increase their bottom line.<sup>6</sup> The information sent should be particularly valuable in a context where information about audits is limited. It is easy to find online data about factors potentially relevant to firms’ decision-making, such as prices, inflation, and exchange rates. Information about tax audit probabilities (and, to a lesser extent, actual penalties paid by evading firms) is much harder to come by. Tax authorities seem to prefer to conceal this information.

<sup>6</sup>We assume that firms in our sample are risk averse—a safe assumption since we deal mainly with small and medium-sized firms. However, AS has also been generalized to settings with risk-neutral agents (Reinganum and Wilde 1985; Srinivasan 1973).



FIGURE 2. SAMPLE LETTER

*Notes:* The baseline letter contains information on the goals and responsibilities of the tax authority. In the space with the text MESSAGE, the baseline letter is empty (see online Appendix A.1 for the full letter). In the audit-statistics letter, a paragraph added to the baseline letter provides information on audit probabilities and tax evasion penalty rates (online Appendix A.2). In the audit-threat letter, firms were randomly assigned to groups with different probabilities (25 percent and 50 percent) of being audited in the following year (online Appendix A.3). The audit-endogeneity letter included information on how evading taxes typically doubles the probability of being audited (online Appendix A.4). Finally, the public-goods letter included a message with information on the cost of evasion in terms of the provision of public goods (online Appendix A.5).



In the audit-statistics letter type, we added to the baseline letter the following paragraph on audit probabilities ( $p$ ) and penalty rates ( $\theta$ ). This letter type was sent to a random sample of firms:<sup>7</sup>

On the basis of historical information on similar businesses, there is a probability of [ $p\%$ ] that the tax returns you filed for this year will be audited in at least one of the coming three years. If, pursuant to that auditing, it is determined that tax evasion has occurred, you will be required to pay not only the amount previously unpaid, but also a fee of approximately [ $\theta\%$ ] of that amount.

We communicated the probability that firms would be audited in at least one of the three following years because IRS experts have found that this is the probability that matters to firms as they make decisions. Uruguayan tax law indicates that tax audits should cover the previous three years of tax returns and, as a result, the probability that the current year's tax filing will be audited is roughly equal to the probability that the firm will be audited at least once over the following three years.

In our sample the average value of  $p$  is 11.7 percent, and the average value of  $\theta$  is 30.6 percent. Tax agencies in most countries do not publish data on the values of  $p$  and  $\theta$ , which makes it difficult to compare the Uruguayan case to others. In the United States, for which some comparable data are available, these two parameters are on the same order of magnitude: self-employed individuals face a  $p$  of 11.4 percent and a base  $\theta$  of 20 percent.<sup>8</sup>

The goal of this treatment arm was to generate exogenous variation in the firms' perceptions of audit probabilities and penalty rates. Because of legal considerations and other constraints, we could not send different firms different sets of information about these factors. We instead induced nondeceptive, exogenous variations in messages that may have an effect on perceptions by exploiting the sampling variation in statistics about audits and penalties. What we did was divide the firms into five groups according to the five quintiles of total VAT payments in the fiscal year before our intervention. For each firm, we then drew a random sample of 50 other firms from the same quintile (i.e., similar firms), for which we computed the averages of  $p$  and  $\theta$ . This randomization strategy generated 940 different combinations of  $p$  and  $\theta$ . These estimates of  $p$  and  $\theta$  were unbiased and consistent with the explanation given in a footnote included in the letter. In other words, the information provided to recipients was nondeceptive. The footnote explained how we estimated the values of  $p$  and  $\theta$ :

Estimates are based on data from the 2011–2013 period for a group of firms with similar characteristics, for instance, in terms of total revenue. The probability of being audited was calculated as a percentage of audited

<sup>7</sup>To make the information on audit probability and penalty rate clear and salient, we provided all figures as round numbers.

<sup>8</sup>First, there is a 2.1 percent probability of being audited in any given year, according to the ratio of returns examined for businesses with no income tax credit and with a reported income of between US\$25,000 and US\$200,000 (IRS 2014, table 9a). Each audit covers the previous 3 to 6 years, which implies that the probability that the current year's tax filing will be audited at some point ranges from 5.88 percent to 11.42 percent. Second, the IRS usually imposes a basic penalty of  $\theta = 20\%$ , although penalties can be higher depending on the situation.

firms in a random sub-sample of firms. The rate of the fee was estimated as an average of a random sub-sample of audits.

The values of  $p$  ranged from 2 percent to 25 percent, with an average of about 11.7 percent. The values of  $\theta$  ranged from 15 percent to 68 percent, with an average of about 30.6 percent. Figure 3 presents the audit-probability and penalty-rate distribution across five groups by firm size (one in each row) and the distribution of the generated within-group parameters. The vertical line denotes the average audit probability or penalty rate based on all members of the group. If we based our estimates of  $p$  and  $\theta$  included in the letter on the population of firms, every member of the group would have received the same signal (the vertical line). Since we computed  $p$  and  $\theta$  from samples of 50 firms, different members of each group received different signals. For example, panel A1 of Figure 3 shows that in group 1 (i.e., the first quintile of firms ranked by total VAT payments), the average  $p$  for all group members is 8.2 percent, whereas the histogram depicts the different signals actually sent to firms within the group. These signals cluster around the average of 8.2 percent, but they range anywhere from 2.5 percent to 25 percent.<sup>9</sup>

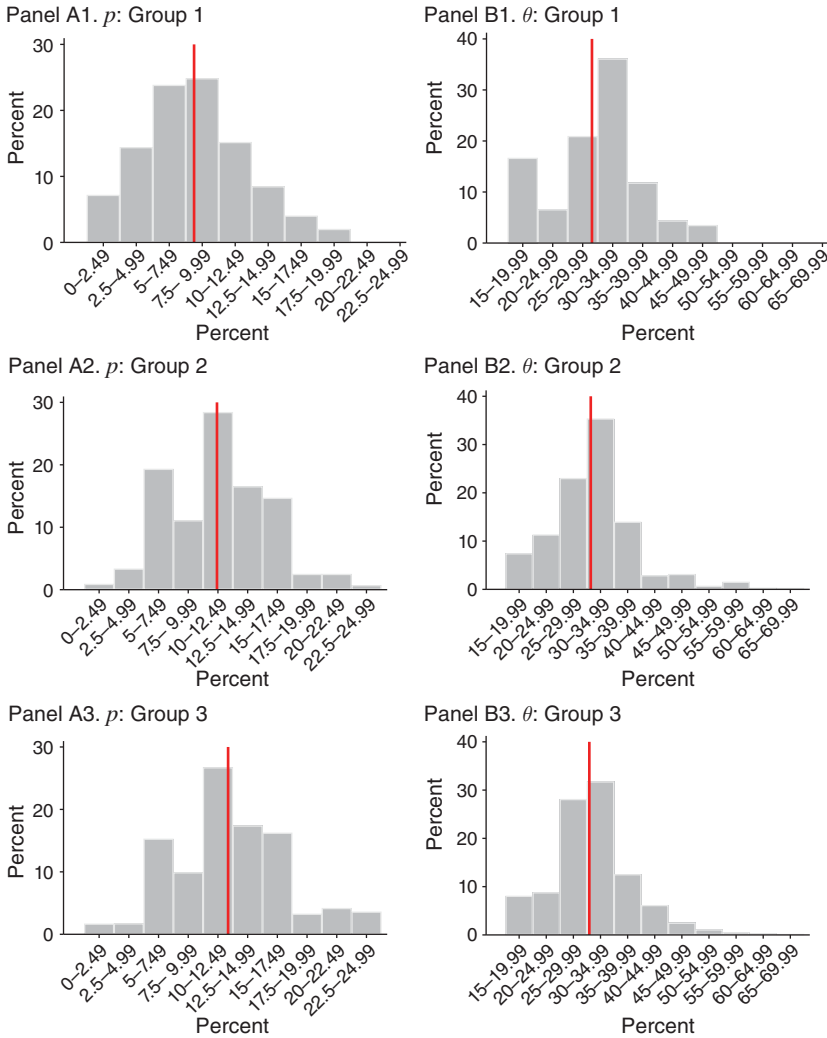
### C. Audit-Threat Letter

To complement the evidence from the audit-statistics subtreatment, we implemented an alternative randomization of perceptions of audit probabilities with an audit-threat letter. We devised a treatment arm that randomly assigned firms to groups with different probabilities of being audited in the following year. The audit-threat letter was identical to the baseline letter, except for the addition of the following paragraph:

We would like to inform you that the business you represent is one of a group of firms pre-selected for auditing in 2016. A [ $X\%$ ] of the firms in that group will then be randomly selected for auditing.

This audit-threat treatment arm was applied to a separate experimental sample, a group of high-risk firms selected by the IRS audit department. The recipients of the audit-threat letter cannot, then, be compared to the recipients of the baseline letter. Instead, we randomly assigned the firms in this treatment arm to two groups, one with a 25 percent probability of being audited in the following year ( $X = 25\%$ ) and another with a 50 percent probability ( $X = 50\%$ ). These messages were nondeceptive: the IRS audit department committed to conducting audits in the following year according to these probabilities.

<sup>9</sup>The within-group average  $p$  differs across the different groups, increasing monotonically from 8.2 percent in the bottom quintile to 13.4 percent in the top quintile. This implies that some of the variation in the values of  $p$  and  $\theta$  included in the letter was nonrandom. To estimate the causal effects of the signals  $p$  and  $\theta$ , we must isolate the random variation when analyzing the data. In any case this aspect of the design is not overly important in practice, as most of the variation in signals is due to the sampling variation. For example, regressing  $p$  on a set of dummy variables for the pretreatment VAT quintiles results in an  $R^2 = 0.135$ . Likewise, regressing  $\theta$  on the same set of dummy variables results in an  $R^2 = 0.009$ .



(continued)

FIGURE 3. DISTRIBUTION OF STATISTICS SHOWN IN AUDIT-STATISTICS LETTERS BY VAT PAYMENT QUINTILES

#### D. Audit-Endogeneity Letter

The audit-statistics and audit-threat treatment arms conveyed quantitative information about audit probabilities and penalty rates, but we wanted to incorporate into our research design a message about a different aspect of the audit process as well. Most tax agencies, including Uruguay’s, consider firm characteristics when deciding which ones to audit. They assign higher audit probabilities to firms with higher evasion risk. As a result, evading taxes typically increases probability of being audited. This factor was incorporated as a special case in AS, in which audit probabilities were determined endogenously. If unsuspecting firms learn about the

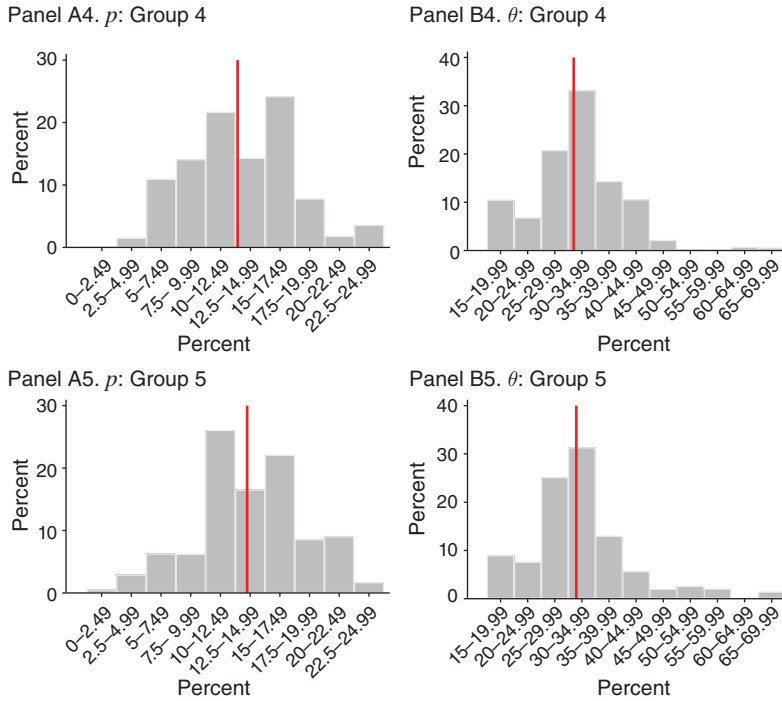


FIGURE 3. DISTRIBUTION OF STATISTICS SHOWN IN AUDIT-STATISTICS LETTERS BY VAT PAYMENT QUINTILES  
(continued)

Notes: Observations = 10,272. These panels show the information provided in the audit-statistics letter, including the probability of being audited ( $p$  in panel A) and the penalty rate ( $\theta$  in panel B). Groups one through five correspond to each of the pretreatment VAT payment quintiles (group one being the bottom quintile and group five being the top quintile). In each panel the red vertical line denotes the average audit probability or penalty rate for all the members of the group.

endogenous nature of their audit probabilities, they should revise their tax evasion decisions and reduce the amount of tax evaded.<sup>10</sup>

We used this insight from economic theory to devise the audit-endogeneity message about the nature of the audit process. We asked our counterparts at the IRS to use their evasion risk scores to divide a small sample of firms into two groups: those suspected of evading taxes and those not suspected of evading taxes. We then computed the difference in audit rates from 2011 to 2013 between the two groups. We found that the rates were approximately twice as high for the likely-evaders group. On the basis of this information, we created the message in the audit-endogeneity letter type, which was identical to the baseline letter except for the addition of the following paragraph:

The IRS uses data on thousands of taxpayers to detect firms that may be evading taxes; most of its audits are aimed at those firms. Evading taxes, then, doubles your chances of being audited.

<sup>10</sup>Konrad, Lohse, and Qari (2017) present suggestive evidence of this mechanism in the context of a laboratory experiment. They find that compliance increases by 80 percent when taxpayers face a situation where a suspicious attitude toward a tax officer increases audit probability.

### E. Public-Goods Letter

We also devised a treatment arm to provide a benchmark for the effect of messages intended to increase tax compliance without directly mentioning audits. We designed a nonpecuniary message based on the suggestions of IRS staff and authorities (i.e., on what information they expected to be most effective at increasing compliance). In the spirit of the model of Cowell and Gordon (1988), this message provided information on the cost of evasion in terms of the provision of public goods.<sup>11</sup> The public-goods letter is identical to the baseline letter, except for the addition of the following message:<sup>12</sup>

If those who currently evade their tax obligations were to evade 10 percent less, the additional revenue collected would enable all of the following: to supply 42,000 portable computers to school children; to build 4 high schools, 9 elementary schools, and 2 technical schools; to acquire 80 patrol cars and to hire 500 police officers; to add 87,000 hours of medical attention by doctors at public hospitals; to hire 660 teachers; to build 1,000 public housing units (50m<sup>2</sup> per unit). There would be resources left over to reduce the tax burden. The tax behavior of each of us has direct effects on the lives of us all.

### F. Survey Design

We designed a survey to be conducted with a sample of firm owners from our main subject pool several months after they received the letters. The IRS, with the support of the Inter-American Center of Tax Administrations and the United Nations, had previously administered a survey on the costs of tax compliance to small and medium-sized firms. We collaborated with the tax authority on the design and implementation of a new survey, which included a module tailored to our research design. The survey also included seven additional modules, designed by the IRS, on the costs of tax compliance and other topics.<sup>13</sup> We partnered with local and international universities to increase respondent confidence and to highlight the fact that the survey was part of a scientific study, not of an audit or compliance exercise by the IRS.

To further ensure trustworthy responses, the IRS assured potential respondents that responses would be anonymous and impossible to trace back to specific individuals or firms. To measure the effect of our experiment on these survey responses, we embedded a code in the survey link to identify which treatment arm of the experiment the recipient was assigned to. While these codes did not uniquely identify any firm, they allowed us to link treatment arms and completed questionnaires without compromising anonymity.

<sup>11</sup> This message is also related to the laboratory experiment from Alm, McClelland, and Schulze (1992), which finds that one of the reasons people decide to pay taxes is appreciation of the public goods provided by tax revenue.

<sup>12</sup> The content of the message was based on estimates from the following governmental agencies: Administracion Nacional de Educacion Publica (ANEP), CEIBAL, Ministerio de Salud Publica (MSP), Ministerio del Interior (MI), Ministerio de Vivienda, Ordenamiento Territorial y Medio Ambiente (MVOTMA).

<sup>13</sup> The email with the invitation to participate in the online survey is reproduced in online Appendix A.6.

In our survey module we used the following two questions to assess whether the audit-statistics message altered recipients' perception of our letters:<sup>14</sup>

**Perceived Audit Probability:** "In your opinion, what is the probability that the tax returns filed by a company like yours will be audited at least in one of the next three years (from 0% to 100%)?"

**Perceived Penalty Rate:** "Let us imagine that a company like yours is audited and that tax evasion is detected. What, in your opinion, is the penalty (in %) as determined by law that the firm must pay in addition to the originally unpaid amount? For example, a fee of X% means that, for each \$100 not paid, the firm would have to pay those original \$100 plus \$X in penalties."

After each question, we asked how certain the subject felt about his or her response on a 1–4 scale, from "Not sure at all" (1) to "Very sure" (4).<sup>15</sup>

## II. Data Sources and Implementation of the Field Experiment

### A. Institutional Context

Uruguay is a middle-income country in South America (the annual GDP per capita was about US\$15,000 in 2015). Our main focus for the study of tax evasion is the VAT, which represents the largest tax liability for firms in Uruguay and also the largest source of tax revenue. At the time of the study, the VAT rate was 22 percent,<sup>16</sup> and VAT revenues accounted for nearly half of total tax revenues.<sup>17</sup> Uruguay is not atypical in terms of tax evasion. According to estimates from Gómez Sabaini and Jiménez (2012), evasion of VAT in Uruguay was around 26 percent in 2008. This is the third-lowest rate in the nine Latin American countries included in the study, and it is comparable to evasion rates in more developed economies. For example, the evasion rate for Italy in 2006 was estimated as 22 percent (Gómez-Sabaini and Morán 2014).<sup>18</sup> Uruguay is not an outlier in terms of tax morale either. According to data from the 2010–2013 wave of the World Values Survey, 77.2 percent of respondents from Uruguay stated that evading taxes is "Never Justifiable," whereas that proportion is, on average, 68.2 percent for all other Latin American countries (weighted by population) and 70.9 percent for the United States.

<sup>14</sup> A screenshot of our survey module is found in online Appendix A.7.

<sup>15</sup> We also included a question in the survey to measure the subject's awareness of the endogeneity of audit probabilities. You can find a screenshot of this question in online Appendix A.7.

<sup>16</sup> A small number of products considered basic necessities had either a 10 percent rate or were exempt from the tax altogether.

<sup>17</sup> Own calculations based on data from the Central Bank of Uruguay and from the Internal Revenue Service. Other sources of tax revenues include personal income tax, corporate income tax, and some specific taxes on consumption, businesses, and wealth.

<sup>18</sup> Gómez Sabaini and Jiménez (2012) compute those rates by applying an "indirect" method to estimate tax evasion. This method is based on the comparison of collected VAT with aggregate consumption data from the System of National Accounts (SNA).



In some contexts tax authorities do not need to rely on audits to mitigate tax evasion. For example, the US Internal Revenue Service uses their electronic records to compare the wage amount reported by a taxpayer to the amount reported by his or her employer. Their algorithm automatically rectifies the discrepancies in reporting and sends a notification to the taxpayer with the updated tax amount to be paid. Because evasion will be caught through third-party reporting regardless of whether the individual is audited, the probability of being audited should be irrelevant to taxpayers (Kleven et al. 2011). We focused on a context where tax authorities still rely heavily on the threat of audits to discourage evasion. There is some third-party reporting for the VAT, namely the paper trail of invoices for sales and purchases.<sup>19</sup> This type of third-party reporting is highly imperfect, however. Most importantly, there is no automatic cross-checking and rectification of VAT payments—that because the paper trail is nonelectronic and thus can only be scrutinized by the tax agency in the event of an audit.<sup>20</sup> The VAT paper trail has other limitations documented in the literature, such as breakdown at the consumer end (Pomeranz 2015; Naritomi 2019). The tax agency has access to other enforcement tools, such as tax withholding, but they have limitations as well. As a result, audits are still one of the main ways the tax agency detects tax evasion in the Uruguayan context (Gómez Sabaini and Jiménez 2012; Bergman and Nevarez 2006).

### B. Subject Pool and Randomization

Our experiment was conducted in collaboration with the IRS of Uruguay. As of May 2015, there were 120,142 firms registered in the agency's database. A subsample of 4,597 firms, preselected by the IRS, was put aside for the audit-threat sample, which we call the secondary experimental sample. We used a series of criteria to select our main experimental sample from the remaining firms. First, we excluded some firms at the request of the IRS, among them very small or very large firms that were subject to special VAT regimes. We also restricted the experimental sample to firms that had made VAT payments for at least 3 different months in the previous 12-month period and to firms with a total value of at least US\$1,000.<sup>21</sup>

To maximize the impact of our information provision experiment, we did our best to ensure that the letters would be delivered to the firms' owners.<sup>22</sup> Moreover, in very large firms the effect of the information could be substantially diluted, as it may not reach the owner or the individuals making decisions about tax compliance. Thus, we

<sup>19</sup>Firms can credit VAT paid on input costs (i.e., imports and purchases from their suppliers) against the total sales of goods and services to their costumers (i.e., "tax debit"). They pay VAT to the IRS only on the excess of the total "tax debit" over the tax credit. If the tax credit exceeds the debit, the difference can be carried over as a credit for future tax years. While the effects of the VAT should, in theory, be similar to those of a retail sales tax, in practice the two types of taxes differ in some significant ways (Slemrod 2008).

<sup>20</sup>The use of standardized electronic invoicing systems may facilitate and automatize the cross-checking of the VAT trail to detect evasion. No such system is in place in Uruguay.

<sup>21</sup>The sample selection was conducted in May 2015, so the 12-month period spans from April 2014 to March 2015.

<sup>22</sup>In some cases owners provide the address of an external accountant rather than their address or their firm's address. We removed from the sample firms that were registered with an accountant's mailing address (the IRS keeps records of addresses for all registered accountants).

excluded from our subject pool firms with a total value exceeding US\$100,000 during the previous 12 months.

These criteria left a subject pool of 20,471 firms for the main experimental sample. All firms were randomly assigned to receive one of the four letter types according to the following distribution: 62.5 percent were assigned to the main treatment arm (audit-statistics letter), and 12.5 percent were assigned to each of the three remaining letter types (baseline, audit-endogeneity, and public-goods).<sup>23</sup> After removing the 19.9 percent of letters returned by the postal service, the final distribution of letter types was as follows: 10,272 received audit-statistics; 2,064 received baseline; 2,039 received audit-endogeneity; and 2,017 received public-goods letters (total Observations = 16,392). The 4,597 firms in the secondary sample were assigned to receive the audit-threat letter. Half were randomly assigned to the message of a 25 percent audit probability, and the other half to the 50 percent audit probability. After excluding the 12 percent of letters returned by the postal service, we were left with 2,015 firms in the 25 percent probability group and 2,033 firms in the 50 percent probability group (total Observations = 4,048).

Table 1 allows us to compare the balance of pretreatment characteristics for firms assigned to the different letter types. Columns 1 through 4 correspond to firms in the main experimental sample. For each characteristic, column 5 presents the  $p$ -value of the test of the null hypothesis that the averages for these characteristics are the same across all four letter types. As expected, the differences across letter types are economically small and statistically insignificant. Columns 6 through 8 of Table 1 present a similar balance test for the secondary sample used for the audit-threat arm. Again, the characteristics are balanced across the two subtreatments in the audit-threat treatment arm.<sup>24</sup>

### *C. Outcomes of Interest*

The letters were mailed by Uruguay's postal service on August 21, 2015, and the vast majority were delivered to taxpayers during the month of September. For that reason, we set September as the last month of the pretreatment period and October as the first month of the posttreatment period. The main outcome of interest is the total amount of VAT liabilities remitted by taxpayers in the 12 months after receiving the letter.<sup>25</sup> To test for the persistence of our treatment effects, a second period of observation, between October 2016 and September 2017 (or up to two years after the intervention), was established. Panel B of Figure 1 depicts a timeline of the experiment and the data collection.

The VAT represented 64.4 percent of the total tax paid by these firms in the fiscal year that preceded our treatment. The corporate income tax represented 25.3 percent

<sup>23</sup>The randomization of letter types was stratified by the quintiles of the distribution of VAT payments over the fiscal year before our intervention.

<sup>24</sup>Online Appendix B.1 provides descriptive statistics for the firms in our subject pool. Moreover, online Appendix B.2 shows that the rate of nondelivered letters is mostly balanced across treatments, with only minor and economically insignificant differences in missing delivery status for the public-goods and audit-endogeneity treatment arms with respect to audit-statistics and baseline.

<sup>25</sup>This variable includes all VAT payments, that is, direct VAT payments and indirect VAT withholdings.

TABLE 1—BALANCE OF FIRM CHARACTERISTICS ACROSS TREATMENT GROUPS

	Main sample					Secondary sample		
	Audit statistics (1)	Public goods (2)	Audit endogeneity (3)	Baseline (4)	<i>p</i> -value test (5)	Audit threat (25 percent) (6)	Audit threat (50 percent) (7)	<i>p</i> -value test (8)
Share paid VAT (3 months pre-mailing)	0.925 (0.003)	0.939 (0.005)	0.926 (0.006)	0.928 (0.006)	0.181	0.897 (0.007)	0.891 (0.007)	0.538
Amount of VAT paid (3 months pre-mailing)	1.872 (0.027)	1.963 (0.067)	1.926 (0.069)	1.906 (0.059)	0.557	1.739 (0.097)	1.748 (0.092)	0.950
Years registered with tax agency	15.338 (0.170)	14.746 (0.224)	15.704 (0.538)	15.009 (0.225)	0.268	19.453 (0.285)	19.425 (0.286)	0.944
Share audited between 2013–2015	0.106 (0.004)	0.097 (0.009)	0.089 (0.009)	0.101 (0.009)	0.302	0.134 (0.010)	0.147 (0.010)	0.382
Number of employees	4.814 (0.264)	4.658 (0.538)	4.880 (0.566)	5.089 (0.635)	0.962	4.835 (0.126)	4.880 (0.117)	0.795
Share filed comprehensive tax return in 2013	0.682 (0.005)	0.687 (0.010)	0.691 (0.010)	0.687 (0.010)	0.871	0.999 (0.001)	1.000 (0.000)	0.558
Share no retail goods sector	0.289 (0.004)	0.293 (0.010)	0.283 (0.010)	0.300 (0.010)	0.621	0.431 (0.011)	0.434 (0.011)	0.845
Share retail goods sector	0.218 (0.004)	0.219 (0.009)	0.214 (0.009)	0.227 (0.009)	0.775	0.334 (0.011)	0.322 (0.010)	0.398
Share services sector	0.493 (0.005)	0.488 (0.011)	0.504 (0.011)	0.473 (0.011)	0.232	0.235 (0.009)	0.244 (0.010)	0.482
Observations	10,272	2,017	2,039	2,064		2,015	2,033	

*Notes:* Averages for different pretreatment firm-level characteristics, disaggregated by treatment group and type of sample (robust standard errors are reported in parentheses). The main sample includes all firms selected as described in Section IIB. The secondary sample includes high-risk firms selected by the IRS for the audit-threat treatment. The last column of each sample reports the *p*-value of a test in which the null hypothesis is that the mean is equal for all the treatment groups. Data on the VAT amount and firm characteristics come from administrative tax records (including monthly payments, annual tax returns, and auditing registers). The amount of VAT reported in row 2 is expressed in constant thousands of US dollars as of August 2015.

of total tax paid, the wealth tax 6.5 percent, and the personal income tax withholding only 3.3 percent. In a context of sole proprietorships, small enterprises, and micro-enterprises, the VAT represents the bulk of firms' tax liability, which is why it is our main focus. We did, however, obtain data from the IRS on the other taxes paid by the firms, which allows us to assess whether firms effectively changed their overall tax compliance or whether they simply substituted the evasion of VAT for evasion of other taxes.

Significantly, the firms in our sample are mostly small. On average, the total amount of VAT paid by the firms that received the baseline letter was about US\$7,700 for the 12-month pretreatment period; the amount for the corresponding posttreatment period was approximately US\$6,500. That negative trend could be explained by the high share of small firms in our sample since small firms tend to have high turnover rates. The size of posttreatment VAT payments varied widely, from US\$440 at the tenth percentile to US\$16,550 at the ninetieth percentile.<sup>26</sup>

We can further break down firms' VAT payments according to timing, observing the date of transfer to the IRS as well as the month for which the payment was imputed. Firms can backdate payments to cover liabilities from previous periods.

<sup>26</sup>See online Appendix B.3 for detailed descriptive statistics on the distribution of pre- and posttreatment payments for firms that received the baseline letter type.

As firms typically make VAT payments on a monthly basis, they normally cover the current and previous months, which we call concurrent payments. We classified payments covering liabilities incurred two or more months prior as retroactive payments—that is, adjustments for revisions in past liabilities. About 99.7 percent of firms made one or more concurrent payments in the 12-month pretreatment period, whereas only 23.11 percent of firms made one or more retroactive payments for this same period.<sup>27</sup>

#### D. Survey Implementation

Since the IRS communicates mainly via post, it has mailing addresses for all registered firms. It also keeps records of email addresses for a subset of firms that have used their online services. We emailed invitations to participate in the survey to all firms in the main experimental sample with a valid email address (Observations = 3,867). We wanted to roll out the survey shortly after the reception of the letters, but, for reasons beyond our control, we were not able to do so until May 2016, nine months after the intervention.<sup>28</sup> We find that firms invited to the survey were similar in characteristics to the broader set of firms in the main experimental sample.<sup>29</sup>

The main purpose of the survey was to elicit the beliefs of firm owners. We did not include email addresses repeated more than three times in the full sample since they likely belonged to accounting firms representing multiple small and medium-sized firms. Even after applying this criterion, the IRS records could not ensure that the registered email address belonged to the firms' owners. We thus asked the survey respondent to self-identify as belonging to one of the following five categories: owner, in-house accountant, external accountant, manager, or other employee. Of the 3,867 recipients invited to participate in the survey, 948 started to answer the survey (a response rate of 24.5 percent).<sup>30</sup> Of these 948, 68.9 percent self-identified as an owner and 23.5 percent as a nonowner; the remaining 7.6 percent did not provide a response to this question.<sup>31</sup> Our baseline specification excludes respondents who self-identified as nonowners, though the results are similar if we include those who identified as nonowners.<sup>32</sup> As per an IRS request, respondents could skip as many questions as they wanted. We find that 6.6 percent and 8.6 percent of respondents skipped the audit probability and penalty questions, respectively, which is

<sup>27</sup> It should be noted that the retroactive payments do not reflect delinquency or outstanding debts to the tax authority. Overall VAT liabilities are computed on a yearly basis, and firms make monthly payments according to their provisional receipts on a pay-as-you-go basis to avoid a large bill at the end of the fiscal year. Thus, retroactive payments reflect changes in past liabilities. For instance, a firm may have "forgotten" to declare a sale in the past and thus needs to send a retroactive payment corresponding to the gap between the original and the updated accounting.

<sup>28</sup> While we would have preferred a shorter interval between the experiment and the survey, its design involved several departments of the tax authority, creating delays.

<sup>29</sup> See online Appendix B.1.

<sup>30</sup> For this calculation, we required that respondents had answered at least the first two questions of the survey.

<sup>31</sup> The nonowner responses are distributed as follows: 6.1 percent self-identified as an internal accountant, 8.3 percent as an external accountant, 2.7 percent as a manager, 6.3 percent as another type of employee.

<sup>32</sup> See online Appendix B.4.2.

comparable to the average rate (6.1 percent) at which they skipped other questions in the survey.<sup>33</sup>

### III. Results: Average Effect of Messages

#### A. Effect of the Audit-Statistics Message

Our first set of hypotheses concern whether providing letters with information on tax enforcement increases tax compliance. We start by describing the effects of our main treatment, the audit-statistics message. The literature suggests that a message of this sort will have a positive effect on tax compliance.<sup>34</sup>

Figure 4 summarizes the raw data before conducting any regression analysis. Panel A of Figure 4 corresponds to the effect of the audit-statistics message. More precisely, the graph shows the percentage difference in VAT paid between the individuals randomly assigned the audit-statistics letter and the individuals assigned the baseline letter.<sup>35</sup> This figure shows the difference for each bimonthly period for all the months for which we have data, including three pretreatment years (October 2012 to July 2015) and two posttreatment years (October 2015 to September 2017).<sup>36</sup> By construction, period zero is defined as the period during which the letters were being delivered (August–September 2015); it is highlighted in the figure with the vertical dashed line. Following Pomeranz (2015), we normalize to the average difference during the entire pretreatment period.

Panel A of Figure 4 shows that the audit-statistics message had an economically significant effect on VAT payments. Prior to the delivery of the letters, and due to random assignment, we would not expect to see differences between individuals assigned one type of letter or another. In other words, individuals cannot possibly be affected by messages they have not yet received. As expected, the differences in VAT payments between the audit-statistics and baseline letter recipients hover around zero in the pretreatment period. Our hypothesis predicts that, after the delivery of the letter, there will be a positive wedge between individuals in the audit-statistics and baseline letter groups. Indeed, a positive gap in VAT payments between the two groups does arise immediately after the receipt of the letters. In the first two months after the letter delivery, the difference in VAT payments between the audit-statistics and baseline letter recipients jumps to 10.4 percent to then hover between 4.0 percent

<sup>33</sup> The skip rate is the probability of providing an answer once a question in the survey has been reached. Online Appendix B.4 presents a series of robustness tests, and other tests, as well as analyses of differential response rates by treatment group.

<sup>34</sup> As long as the enforcement messages do not affect the taxpayers' true income, the changes in the total amount of VAT paid measure changes in tax evasion. Given the presence of real effects, however, our estimates provide a lower bound for the impact of tax-enforcement information on compliance. Although real effects are possible in our setting, most of the public finance literature provides evidence that real effects are normally zero or small relative to reporting effects (see, for example, Saez, Slemrod, and Giertz 2012).

<sup>35</sup> Online Appendix B.5 discusses the evolution of VAT payments for the treatment and control groups separately.

<sup>36</sup> Since a number of firms are required to pay VAT on a bimonthly basis and there is a strong seasonal pattern, we group the data into bins of two months. In all results the amounts are top-coded at the 99.99 percent percentile to avoid contamination by outliers.

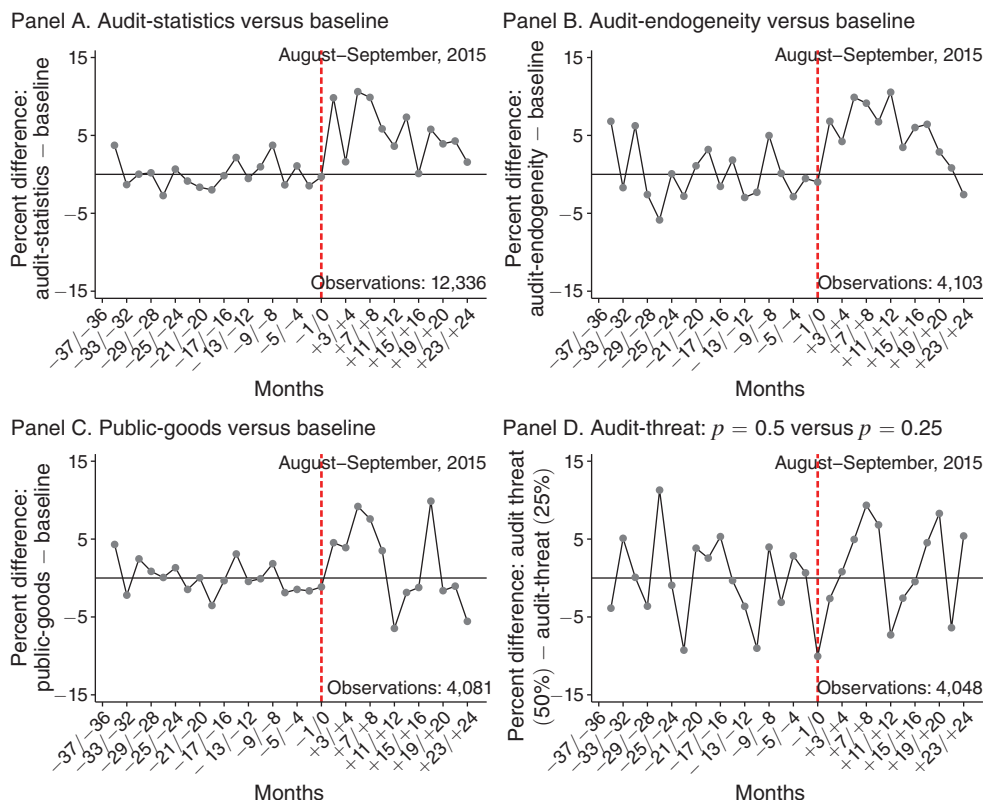


FIGURE 4. EFFECTS OF AUDIT-STATISTICS, AUDIT-ENDOGENEITY, PUBLIC-GOODS, AND AUDIT-THREAT MESSAGES ON VAT PAYMENTS

*Notes:* These figures plot the percentage difference in bimonthly total VAT payments between treatment and control groups, normalized by the average pretreatment percentage difference (i.e., between months  $-35$  and  $0$ ) for the same outcome. The data cover the period from October 2012 to September 2017. The months of August and September 2015—when most of the letters were delivered—are defined as the reference bimonthly period (and marked with the dashed vertical line). Panel A presents the effect of the audit-statistics message (i.e., the difference between audit-statistics and baseline letters), while panel B represents the effect of the audit-endogeneity message and panel C depicts the effect of the public-goods message. Panel D presents the difference between being assigned a 50 percent probability of being audited ( $p = 50\%$ ) and a 25 percent probability of being audited ( $p = 25\%$ ) in the audit-threat letters. For each pair of months, VAT payments are top-coded at the 99.99 percent percentile to avoid contamination of the results by outliers.

and 10.5 percent for the rest of the first posttreatment year. Starting in the second year, the effect grows weaker over time.

While these results suggest that the audit-statistics message increased subsequent VAT payments, a more formal framework is required for statistical inference. We observe the outcome variable both before and after the intervention. The resulting information reduces variance in the error term and thus gains statistical power through a difference-in-difference specification that compares treated firms to control firms and the pretreatment period to the posttreatment period (McKenzie 2012). We then follow the econometric specification from Pomeranz (2015). Consider the sample of firms assigned either the baseline letter or the audit-statistics letter. Let  $i$  index firms and  $t = \{1, 2\}$  denote time, where  $t = 1$  corresponds to the 12 months



pretreatment and  $t = 2$  to the 12 months posttreatment. Let  $Y_{it}$  be the outcome variable by taxpayer  $i$  in period  $t$  (e.g.,  $Y_{i,2}$  could be the total VAT payments by firm  $i$  in the 12-month posttreatment period).  $D_i^1$  is a dummy variable that takes value one if  $i$  was assigned to receive the audit-statistics letter and zero if it was assigned to receive the baseline letter. Let  $Post_t$  be a dummy variable that takes the value one if  $t = 2$  (i.e., after the letters were delivered) and zero if  $t = 1$ . The regression of interest is as follows:

$$(1) \quad Y_{it} = \alpha_0 + \gamma_1 \cdot D_i^1 \cdot Post_t + \alpha_1 \cdot D_i^1 + \alpha_2 \cdot Post_t + \epsilon_{it}.$$

The coefficient of interest is  $\gamma_1$ , which measures the differential effect between the audit-statistics letter and the baseline letter. When the dependent variable is the amount of tax paid, we estimate a log-linear model, also known as a Poisson regression, for two reasons. First and foremost, in the Poisson regression effects are proportional—indeed, the coefficients can be readily interpreted as semielasticities.<sup>37</sup> Second, the Poisson regression naturally accounts for the bunching at zero of the dependent variable. Note that the Poisson regression can be used for a continuous nonnegative variable; we do not have to rely on additional functional form assumptions such as equidispersion thanks to the quasi-MLE estimator.<sup>38</sup> In any case we find that the results are robust to alternative regression models (OLS, Tobit, and Probit).<sup>39</sup> Standard errors are always clustered at the firm level.

Table 2 presents the baseline regression results. Panel A compares the audit-statistics and baseline letters. In column 1 the dependent variable corresponds to the effect on VAT paid. The posttreatment coefficient corresponds to the effect during the 12 months after the delivery of the letter (October 2015 to September 2016), as measured by the coefficient  $\gamma_1$  from equation (1) above. The posttreatment coefficient of audit-statistics (in column 1 of panel A) is positive (0.070) and highly significant statistically ( $p$ -value = 0.001) and economically, suggesting that the audit-statistics message increased VAT payments in the 12 months after the intervention by about 7.0 percent.<sup>40</sup> To better grasp the magnitude of the effects, we can compare them to some basic benchmarks. The estimated average evasion rate for VAT in Uruguay is 26 percent (Gómez Sabaini and Jiménez 2012), and while the tax base is not necessarily comparable, it does provide a benchmark: the 7 percent increase in VAT payments amounts to a reduction in the evasion rate of 27 percent ( $= \frac{7.0\%}{26\%}$ ). The effects of our audit-statistics treatment are not directly comparable to the effects of the audit message from Pomeranz (2015) because the messages differed in content and each study covers firms from different countries and with

<sup>37</sup>The Poisson model can be expressed as follows:  $\log(Y_X) = \alpha + \beta X + \epsilon$ . The effect of a unit change in  $X$  can be reexpressed in log-units of the dependent variable,  $\beta = \log(Y_{X=x+1}) - \log(Y_{X=x})$ . Provided this coefficient is small enough, it can be approximated as a percent-change effect.

<sup>38</sup>For more details, see, for example, Wooldridge (2010, chap. 19).

<sup>39</sup>See online Appendix B.6.1 for the results from these robustness checks.

<sup>40</sup>This percent effect is based on the following approximation:  $\beta = \log(Y_{X=x+1}) - \log(Y_{X=x}) \approx \frac{Y_{X=x+1} - Y_{X=x}}{Y_{X=x}}$ . For the sake of simplicity, in the rest of the paper, we interpret all of the Poisson coefficients using this same approximation. The exact percent effect can be calculated exactly using the exponential transformation. For example, the 0.070 coefficient corresponds exactly to a 7.25 percent effect ( $= 100 \cdot (e^{0.070} - 1)$ ).

TABLE 2—AVERAGE EFFECTS OF AUDIT-STATISTICS, AUDIT-ENDOGENEITY, AND PUBLIC-GOODS MESSAGES ON VAT AND OTHER TAX PAYMENTS BY TIME HORIZON AND PAYMENT TIMING

	By time horizon		By payment timing		By tax type	
	First year (1)	Second year (2)	Retroactive (3)	Concurrent (4)	Non-VAT (5)	VAT + non-VAT (6)
<i>Panel A. Audit-statistics (10,272 firms) versus baseline (2,064 firms)</i>						
Posttreatment	0.070 (0.021)	0.032 (0.027)	0.383 (0.140)	0.053 (0.021)	0.086 (0.037)	0.073 (0.020)
Pretreatment	0.009 (0.020)	0.004 (0.026)	-0.048 (0.118)	0.012 (0.020)	0.008 (0.043)	0.014 (0.021)
<i>Panel B. Audit-endogeneity (2,039 firms) versus baseline (2,064 firms)</i>						
Posttreatment	0.071 (0.028)	0.032 (0.036)	0.264 (0.160)	0.061 (0.028)	0.090 (0.054)	0.078 (0.028)
Pretreatment	-0.005 (0.028)	-0.009 (0.035)	0.097 (0.164)	-0.010 (0.028)	0.056 (0.055)	0.017 (0.028)
<i>Panel C. Public-goods (2,017 firms) versus baseline (2,064 firms)</i>						
Posttreatment	0.051 (0.025)	0.004 (0.032)	0.208 (0.170)	0.043 (0.025)	0.067 (0.043)	0.056 (0.024)
Pretreatment	-0.003 (0.024)	-0.017 (0.033)	-0.088 (0.163)	0.001 (0.024)	-0.038 (0.054)	-0.015 (0.026)

*Notes:* Standard errors reported in parentheses are clustered at the firm level. Treatment effects are estimated using the difference-in-difference specification reported in equation (1), which compares treated firms to control firms and pretreatment to posttreatment periods using yearly aggregated variables. The results are based on Poisson regressions, so the coefficients can be interpreted directly as semielasticities. Panel A compares the audit-statistics message with the baseline letter, while panels B and C replicate the comparison for the audit-endogeneity and public-goods messages, respectively. In the first row of each panel (“Posttreatment”), the coefficient reported corresponds to a comparison between a posttreatment period and a pretreatment period. The second row (“Pretreatment”) presents a falsification test where two pretreatment periods are compared. Columns 1 and 2 report the effect of treatment by time horizon. The posttreatment effect reported in column 1 corresponds to the difference-in-difference estimate that compares October 2015–September 2016 to October 2014–September 2015. The posttreatment effect reported in column 2 is analogous but uses the second year after the treatment as the posttreatment period (i.e., October 2016–September 2017). For the falsification tests, column 1 is based on a comparison between October 2014–September 2015 and October 2013–September 2014, while column 2 compares October 2014–September 2015 to October 2012–September 2013. Columns 3 and 4 present the first-year effect of treatment on retroactive and concurrent VAT payments. Columns 5 and 6 report the first-year results by type of tax. Column 5 presents the effect of the treatment on other (non-VAT) tax payments, while column 6 reports the effect on the total amount of taxes paid by the firms during the same period. In all cases we restrict the analysis to firms that effectively received the letter as reported by the postal service.

different characteristics. Nevertheless, table 4 from Pomeranz (2015) indicates that the deterrence letter led to an increase in VAT payments of 7.6 percent, a figure similar in magnitude and statistically indistinguishable from the 7.0 percent effect of our audit-statistics message. Moreover, our results are qualitatively consistent with a broader literature that finds messages about enforcement to have an effect on tax compliance in a variety of contexts: self-employed income in the United States (Slemrod, Blumenthal, and Christian 2001), wage income taxes in Denmark (Kleven et al. 2011), individual TV license fees in Austria (Fellner, Sausgruber, and Traxler 2013), individual municipal taxes in Argentina (Castro and Scartascini 2015), an individual church tax in Germany (Dwenger et al. 2016), and tax delinquencies in the United States (Perez-Truglia and Troiano 2018).

Table 2 presents a number of robustness checks discussed below. First, we present falsification tests in the spirit of event-study analysis. The pretreatment coefficients from Table 2 are estimated with a specification identical to the one used for the posttreatment coefficients, except for the use of a “placebo” date for the delivery of the letters: i.e., we simulate that the letters were delivered in August and September 2014 and estimate the “effects” on the VAT paid in the subsequent 12 months (i.e., October 2014 to September 2015). Since the letters had not actually been delivered on that date, we would expect the “effect” of the audit-statistics message to be close to zero and statistically insignificant. A finding to the contrary would suggest problems with the specification or the random assignment. As expected, the pretreatment coefficients for the audit-statistics message (column 1 in panel A of Table 2) is close to zero (0.009), statistically insignificant ( $p$ -value = 0.658), and as precisely estimated as the corresponding posttreatment coefficient.

Over time, individuals may forget the information conveyed in the letter or it may become less salient. Beliefs and perceptions may change for other reasons, for instance, new events such as audits and information campaigns. To assess the persistence of the effects, column 2 in Table 2 replicates the analysis for the second year after treatment (October 2016 to September 2017). As expected, the effect of the treatment is half as large as it is during the first year and no longer statistically significant. These estimates are consistent with the pattern of effects by quarter depicted in panel A of Figure 4: the effect decreases gradually over time and is about half as large in the second year as in the first. The timing of the effects is also consistent with previous evidence on the effects of tax enforcement messages. The effects of the main intervention in Pomeranz (2015) were also substantially higher in the first 12 months after the intervention, at which point they fell substantially; by the eighteenth month, they had largely vanished.<sup>41</sup>

Table 2 presents results for complementary outcomes. Firms in Uruguay, as explained in the previous section, make payments not only for their current liabilities but also for previous periods either because accounts are revised and past mistakes remedied or because invoices not available at the time of the original payment are now imputed. When firms that engage in tax evasion face a heightened threat of audit, we can expect them not only to increase tax payments (i.e., reduce their evasion) in the future but also to revise their payments for previous periods to reduce or eliminate past evasion. To shed light on this question, columns 3 and 4 in panel A of Table 2 split the effects during the first year between retroactive and concurrent payments. The audit-statistics message had an economically and statistically significant effect on both retroactive and concurrent payments: the coefficient corresponding to the audit-statistics message is 0.383 ( $p$ -value = 0.006) for retroactive payments and 0.053 ( $p$ -value = 0.012) for concurrent payments.<sup>42</sup>

We have so far established that firms in the audit-statistics treatment arms increased their VAT payments compared to those in the baseline letter group. Our

<sup>41</sup> See, for example, Pomeranz (2015, figure 2).

<sup>42</sup> While the size of the effect for retroactive payments is larger than for concurrent payments, these differences must be taken with a grain of salt because there are large differences in baseline levels between the two outcomes. In the baseline letter group, for example, firms paid an average of US\$300 in retroactive payments versus US\$6,160 in concurrent payments in the posttreatment period.

analysis focuses on VAT liabilities, which represent the largest fraction of tax payments made by firms in our sample. Our letters referred to taxes in general, however, not VAT or any other tax in particular, which means the effects we reported for VAT may not actually represent a net increase in tax payments: firms may increase their evasion (i.e., reduce their payments) of other tax liabilities, thereby crowding out payments or substituting evasion to other taxes. On the other hand, firms may need to declare higher income in order to declare higher VAT and thus be required to pay more, not less, in non-VAT taxes. The results in columns 5 and 6 of Table 2 shed light on these issues. Column 5 presents the effects on all other taxes paid (mostly the corporate income tax). The effects on the payments of other taxes are as economically and statistically significant as the effects on VAT payments: the audit-statistics message had an effect of 8.6 percent ( $p$ -value = 0.019) on other tax payments. Column 6 shows that the results are robust if we look at the effect on the sum of VAT and other taxes: the audit-statistics message increased this outcome by a statistically significant 7.3 percent ( $p$ -value < 0.001).<sup>43</sup>

### B. Audit-Endogeneity Message

The first benchmark for the audit-statistics message is the audit-endogeneity message; the two are similar in that both provide information on tax enforcement through audits. Panel B of Figure 4 shows the raw evolution of VAT payments in the audit-endogeneity treatment relative to the baseline treatment. The results suggest that the audit-endogeneity message also induced a significant increase in VAT payments and that that increase was similar in timing and magnitude to the effects induced by the audit-statistics message depicted in panel A of Figure 4. For a more formal statistical analysis, the regression results are presented in panel B of Table 2.<sup>44</sup> The coefficient in column 1 indicates that the audit-endogeneity message increased subsequent VAT payments by 7.1 percent ( $p$ -value of 0.009).<sup>45</sup> This 7.1 percent is similar in magnitude and statistically indistinguishable ( $p$ -value = 0.950) from the corresponding 7.0 percent effect of the audit-statistics message reported in panel A.<sup>46</sup> The same robustness checks were performed on the effects of the audit-endogeneity message as on the effects of the audit-statistics message: for example, the “effect” on the pretreatment year is close to zero ( $-0.005$ ) and statistically insignificant ( $p$ -value = 0.868), and the effects during the second posttreatment year are about half as large as during the first year.

<sup>43</sup>Online Appendix B.7 presents both a finer analysis that breaks down the effects of “other taxes” into their three components and a series of additional robustness checks, such as alternative estimation methods (online Appendix B.6.1); alternative specifications of the dependent variable (online Appendix B.6.1); and a heterogeneity analysis based on firm characteristics such as size, age, and sector (online Appendix B.8). Overall, we find that the effects are qualitatively and quantitatively similar across the board.

<sup>44</sup>The results from panels B and C in Table 2 are based on a regression specification equivalent to the one from equation (1) above, which was used to obtain the estimates in panel A.

<sup>45</sup>The estimate of the effect of the audit-endogeneity message is somewhat less precise than the effect of the audit-statistics message, but that is as expected due to the difference in sample sizes.

<sup>46</sup>This is an equality test between two coefficients based on the same data but different regressions. To allow for a nonzero covariance between these two coefficients, we estimate a system of seemingly unrelated regressions. In the remainder of the paper, when comparing coefficients from the same data but different regressions, we will use this method.

### C. Public-Goods Message

Panel C of Figure 4 shows the effects of the public-goods message on VAT payments. The time series data suggest that the public-goods message also had a positive effect on tax compliance, but that effect dissipated a lot more quickly than the effects of the audit-statistics message. The corresponding regression results are presented in panel C of Table 2. The public-goods message increased VAT payments in the first posttreatment year by 5.1 percent, and the effect is statistically significant ( $p$ -value = 0.043). The effects of the public-goods message in the second posttreatment year, however, were close to zero (0.4 percent) and statistically insignificant ( $p$ -value = 0.906). The evidence on the effects of moral messages is mixed, and they appear to work in some contexts (Bott et al. 2020; Nathan, Perez-Truglia, and Zentner 2020; Hallsworth et al. 2017) but not others (Blumenthal, Christian, and Slemrod 2001; Fellner, Sausgruber, and Traxler 2013; Castro and Scartascini 2015; Dwenger et al. 2016; Meiselman 2018; Perez-Truglia and Troiano 2018). A closely related study, Pomeranz (2015), included a message of moral suasion that had a positive effect on subsequent VAT payments, although that effect was statistically insignificant and not as large as the effect of the deterrence message. Our findings on moral suasion fall closest to the findings of the experiment with Norwegian taxpayers reported in Bott et al. (2020): they find that the message of moral suasion increased tax compliance in the short term, but the effects dissipated completely the following year.

## IV. Tests of AS

The results presented in the previous section are broadly consistent with the evidence in the literature, namely, providing information on audits significantly increases tax compliance. In this section we present additional evidence to establish whether the effects of the audit-statistics treatment are driven by the AS mechanism.

### A. First Test of AS: Effects on Perceptions

According to AS, the audit-statistics message would have a positive effect on tax compliance if it increased the perceived probability of being audited, the perceived value of the evasion fine, or both. We explore this hypothesis by utilizing data from our posttreatment survey, with 365 firms in the audit-statistics group and 137 in what we refer to as the pooled control group, that is, individuals who did not receive information on audits.<sup>47</sup>

Panels A and B of Figure 5 depict the distributions of perceptions of audit probabilities and penalty rates as elicited from the survey. The shallow bars with solid borders correspond to the perceptions of firms that received the audit-statistics message. The shaded gray bars depict the distribution of perceptions of firms in the

<sup>47</sup>The size of the survey sample was substantially smaller than the size of our experimental sample. To increase the statistical power of our test, we pooled subjects from the baseline and the public-goods groups to make up the control group since both received messages with no specific information on audit probabilities or fines. Online appendix B.4.2 shows that the results are similar, but less precisely estimated, when the control group includes only recipients of the baseline letter.

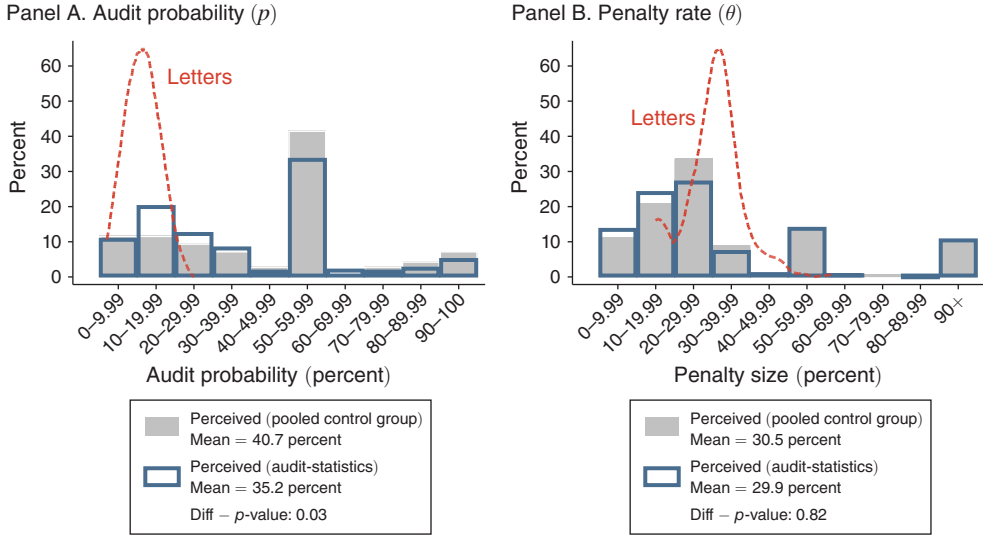


FIGURE 5. SURVEY RESULTS: PERCEPTION OF AUDIT PROBABILITIES AND OF TAX EVASION PENALTY RATES BY TREATMENT GROUP

*Notes:* The histograms are based on the survey responses of individuals who did not self-identify as nonowners. *Perceived (pooled control group)* (Observations = 137) refers to survey respondents who received the baseline (Observations = 69) or the public-goods (Observations = 68) letters during the experimental stage (neither of those letters contained any information on audit probabilities or penalty rates). *Perceived (audit-statistics)* refers to respondents who received the audit-statistics letters (Observations = 365). In panel A the x-axis represents the probability of being audited; in panel B it represents the average penalty rate. We report the mean responses and the  $p$ -value of the difference between the two groups. The answers correspond to Q2 and Q4 in the survey (see full survey questionnaire in online Appendix A.7). The red line represents the density function of the information displayed in the audit-statistics letters, measured in the right y-axis (hidden for the sake of clarity).

pooled control group. The red dashed curve, in turn, corresponds to the distribution of signals sent to firms in the audit-statistics letters. A comparison of the shaded bars and the red curve from panel A of Figure 5 suggests that, on average, respondents in the control group substantially overestimated the probability of being audited. While our administrative data on audits indicate a probability of being audited of about 11.7 percent, the mean perception for the control group is 40.7 percent ( $p$ -value < 0.001 for the difference). This finding of an overestimation of audit probabilities is consistent with prior survey evidence (Harris and Associates 1988; Erard and Feinstein 1994; Scholz and Pinney 1995).<sup>48</sup> A comparison of the shaded bars and the red curve from panel B of Figure 5, meanwhile, suggests that the average belief about the penalty rates was unbiased: the actual average penalty computed from administrative data for the experimental sample is 30.6 percent, while the mean perceived penalty for in the control group is 30.5 percent.

<sup>48</sup>The prior survey evidence was based on responses from wage earners, however, for whom misperception of audit probabilities is largely inconsequential due to widespread third-party reporting (Kleven et al. 2011). On the contrary, the financial stakes of misperceiving audit probabilities can be substantial in our context.



The positive bias in the perceived audit probability could be explained by the availability heuristic bias (Tversky and Kahneman 1974), according to which individuals judge the probability of an event on the basis of how easily they recall instances of it happening. Even though audits are rare, their likely salience in memory or frequent discussion by colleagues and the media may induce firms to perceive them as more frequent than they actually are. Indeed, there is evidence that individuals overestimate the probabilities of a wide range of rare events of a similar nature (probabilities of dying in a terrorist attack or in an airplane accident (Lichtenstein et al. 1978; Kahneman, Slovic, and Tversky 1982)).

The survey data indicate that the effects of the audit-statistics message are inconsistent with the AS predictions. According to AS, if taxpayers overestimate the audit probabilities on average, the audit-statistics message would have reduced average tax compliance. The results presented in the previous section show that, on the contrary, the audit-statistics message increased average compliance.<sup>49</sup> To bolster this argument, we show that the audit-statistics letter did indeed have a negative effect on perceived audit probability.<sup>50</sup> The shallow bars with solid borders in panel A of Figure 5 show the distribution of perceptions for respondents who received the audit-statistics letter. An inspection of panel A of Figure 5 indicates that recipients of the audit-statistics letter reported a lower perceived probability of being audited, from an average of 40.7 percent in the pooled control group to an average of 35.2 percent in the audit-statistics group ( $p$ -value of the difference 0.03).<sup>51</sup> The mechanisms behind the audit-statistics message are relevant to the interpretation of the audit-endogeneity message: subjects may have learned that the audits are endogenous through the audit-endogeneity message and reoptimized their tax evasion accordingly; or they could have had a knee-jerk reaction to any information about audits, even if they were already aware of the endogeneity component. Consistent with the evidence on the audit-statistics message, we find that the effect of the audit-endogeneity message was probably not due to a change in recipients' beliefs: recipients were already aware of the endogeneity.

*Concerns with Survey Data.*—This first test relies on survey data, and as such it faces some challenges common to this type of data. In this section we discuss and address some of those challenges.

One potential concern is that the responses on audit probabilities and penalty rates mostly reflect measurement errors because the questions were not incentivized. There are several pieces of evidence suggesting otherwise. First, the fact that

<sup>49</sup> One caveat of the test presented in this section, and for the test presented in the section below, is that we are estimating the effects on the average firm. The fact that the average firm does not behave as AS predicts does not imply that none of the firms do. It is possible, for instance, that some firms altered their perceived probability upward because of the information contained in the letter and increased their tax payments as a consequence. The fact that the average effects are so far from the AS prediction suggests, however, that the firms behaving as AS predicted must have been a minority at most.

<sup>50</sup> One caveat here: a reduction in the self-reported probability of being audited could be caused by an increase in tax compliance due to the endogenous nature of  $p$  with respect to tax evasion.

<sup>51</sup> Panel B of Figure 5 shows that the audit-statistics message had a small effect on the perceived penalty rate, decreasing it from an average of 30.5 percent for the pooled control group to an average of 29.9 percent for the audit-statistics group. The difference is statistically insignificant ( $p$ -value of 0.82). For more details, see online Appendix B.4.3.

the survey beliefs changed depending on the information provided in the letters suggests that these responses contained some truthful information. Second, while there is a large positive bias in the perception of audit probabilities, the average perception of the penalty rate (30.5 percent) is extremely close to the actual probability computed from administrative data (30.6 percent). The fact that belief and reality line up to such an extent suggests that individuals responded honestly and thoughtfully. Furthermore, individuals were better informed about penalty rates than about audit probabilities, which is also consistent with the fact that there is more readily available information about penalty rates: audits are relatively rare events, and their probabilities are not advertised, whereas evasion penalties are more widely broadcast by the tax agency.

Another potential issue is that respondents were aware that they were misinformed and would never have acted on their biased beliefs. Our survey data provide evidence to the contrary. Even though their estimates were substantially off, survey participants reported being confident of their responses. For example, only 16.2 percent of those in the control group reported being “Not at all sure” about their perceived probability of audit (on a 4-point scale, ranging from “Not at all sure” to “Very sure”); a similar share (18.1 percent) reported being “Not at all sure” about their guess of the penalty rate. Even for the subgroup of individuals in the control group who reported being “Very sure” of the audit probability, their average belief was, if anything, slightly more biased: they reported a perceived audit probability of 45.7 percent, which is still substantially higher than the actual probability of 11.7 percent.

Another concern is that our subjects may have been confused about the questions; perhaps they did not understand the definition of an “audit.” Of the 137 responses from the pooled control group, 10.2 percent of firms reported having been audited in the past 3 years. This share (10.2 percent) is close to the actual share of firms that were audited (11.7 percent), thus suggesting that respondents correctly understood the definition of an audit. Moreover, if firms use their own audit history to form their beliefs about audit probabilities, the ones that had been audited recently should report a higher perceived probability. Indeed, we found that to be the case: firms that had recently been audited reported a substantially higher average perceived probability of being audited in the future (63.9 percent) than firms that had not been audited recently (38.1% –  $p$ -value of the difference  $< 0.001$ ). Subjects could, conceivably, have cognitive limitations when responding to questions about percentages and probabilities. That would be a minor concern in our subject pool since it is comprised of business owners likely familiar with fractions and probabilities. While no verifying administrative data are available, the anecdotal evidence indicates that our sample is a highly educated subgroup of the population. After all, these business owners need, at the very least, some rudimentary arithmetic skills and understanding of percentages to compute the VAT and other tax liabilities.

Another potential concern is that respondents report a probability of 50 percent as a way of expressing uncertainty (Bruine de Bruin et al. 2002; Bruine de Bruin and Carman 2012). Responses of exactly 50 percent are somewhat common in our data: among individuals in the pooled control group, 41.61 percent of responses about perceived audit probability and 13.5 percent about penalty rate are equal to exactly

50 percent. Our data indicate, however, that most of these responses of exactly 50 percent are not a product of uncertainty: individuals who provided an answer of 50 percent are somewhat, but not dramatically, less certain of their responses than individuals who provided answers different from 50 percent.<sup>52</sup> Moreover, even if we ignored the 50 percent responses, the main result would still be robust: individuals in the control group still substantially overestimate the probability of being audited (average perception of 34.1 percent, compared to the actual probability of 11.7 percent).<sup>53</sup>

As an additional validation of the survey data, we can measure the effect of the signals on  $p$  and  $\theta$  from the audit-statistics subtreatments, though this exercise is limited due to the small sample size (we only have 365 survey responses in the audit-statistics group). With that caveat in mind, the survey data suggest that a percentage point increase in the signal on audit probability in the letter increased the perceived audit probability 9 months later by 0.397 (SE 0.288) percentage points.<sup>54</sup> While imprecisely estimated and thus statistically insignificant at conventional levels, the magnitude of this belief updating is consistent with the findings from other information-provision experiments (see Section IVB for a more detailed discussion). The true effects of the signals in the letter on beliefs were probably greater than the above estimates suggest, due to different sources of noncompliance.<sup>55</sup>

We provide an alternative to this test that does not rely on survey data.<sup>56</sup> We assume that, due to the paucity of information publicly available on the auditing process, firms form prior beliefs on audit probabilities based on their own exposure to audits. Take, for instance, two firms that have been paying taxes for ten years, where, by chance, one of them has been audited at some point and the other has not. The firm that has been audited in the past will have a higher perceived probability of being audited in the future. The results from this alternative test also provide evidence against the AS mechanism.

<sup>52</sup>In the pooled control group, the average certainty of perceived audit probability is 2.03 (in the 1–4 scale from “Not at all sure” (1) to “Very sure” (4)) for individuals who responded with a value of exactly 50 percent and 2.37 for individuals who responded with a different value ( $p$ -value of difference  $< 0.001$ ). For responses about perceived penalty rate, the average certainty is 2.11 for individuals who responded with 50 percent and 2.51 for those who responded with another value ( $p$ -value of difference = 0.001).

<sup>53</sup>For more details, see online Appendix B.4.2.

<sup>54</sup>For more details, see online Appendix B.4.4.

<sup>55</sup>While we are confident that our certified letters reached the firms’ owners, we cannot be as confident that the owner was the one who received the email invitation to complete the survey. And while we wanted to conduct the survey shortly after the letter campaign, we were not able to roll it out until nine months after the intervention for reasons beyond our control. In information-provision experiments of this type, the effect of information on beliefs tends to decay substantially in a matter of a few months—recipients may forget the information provided in the letters or acquire additional information in the meantime. For example, Cavallo, Cruces, and Perez-Truglia (2017) show that the effect of information on beliefs decays by about half in a matter of just three months, and similar findings are reported by Botta and Perez-Truglia (2022) and Fuster et al. (2022). All these factors will lead to an underestimation of the effects of the letter on beliefs.

<sup>56</sup>For more details, see online Appendix B.9.

### B. Second Test of AS: Heterogeneity with Respect to Signals

The second test is based on the differential effects of the values of the signals in the letters. According to AS, the effects of the audit-statistics message should increase in the signals on audit probability ( $p$ ) and penalty rate ( $\theta$ ), a hypothesis we tested directly with the random variation we introduced in the  $p$  and  $\theta$  in our audit-statistics letter. We first present our estimates of these elasticities and then compare them with the values obtained from calibrations of the AS model.

*Elasticities with Respect to  $p$  and  $\theta$ .*—For a less parametric look at the data, Figure 6 estimates the effect of the audit-statistics message on VAT payments but broken down by decile of the signals in the letter.<sup>57</sup> Panel A of Figure 6 presents the effect of the audit-statistics message by decile of the signal on  $p$  shown in the letter. In the AS framework we would expect very low signals of  $p$  to reduce tax compliance (since they most likely reduced firms' perceived probability of audits); the effect would become larger, and turn positive at some point, as the signal on  $p$  is increased. The coefficients plotted in panel A of Figure 6, however, indicate that the effect of the audit-statistics letter is not related to the value of  $p$  included in the letter. The coefficients are similar in magnitude for the whole range of values from  $p = 2\%$  all the way up to  $p = 25\%$ . Moreover, the resulting linear relationship (shown as a dashed red line) has a slope that is close to zero and statistically insignificant. Panel B of Figure 6 provides a similar analysis for the heterogeneity by penalty rates ( $\theta$ ) in the letter. According to AS, we would expect a positive relationship between the effect of the audit-statistics letter and the value of  $\theta$  in the letter. Panel B of Figure 6 shows evidence to the contrary: the coefficients are similar for the whole range of values from  $\theta = 15\%$  to  $\theta = 68\%$ , and the slope is close to zero and statistically insignificant.

With a more parametric approach, we can quantify the effects of the audit-statistics sub-treatments so that they can be contrasted with the quantitative predictions of AS. For the audit-statistics treatment arm, we use the following model:

$$(2) \quad Y_{it} = \alpha_0 + \gamma_p \cdot p_i \cdot Post_t + \gamma_\theta \cdot \theta_i \cdot Post_t + \alpha_1 \cdot p_i + \alpha_2 \cdot \theta_i + \alpha_3 \cdot Post_t \\ + \sum_{g=2}^5 \alpha_{4,g} \cdot I_{\{i \in g\}} + \sum_{g=2}^5 \alpha_{5,g} \cdot I_{\{i \in g\}} \cdot Post_t + \epsilon_{it},$$

where  $p_i \in (0, 1)$  is the signal on audit probability included in the letter sent to firm  $i$  and  $\theta_i \in (0, 1)$  is the signal on penalty rate included in the letter sent to the same firm. The  $I_{\{i \in g\}}$  variables correspond to a set of dummies for the quintiles of pretreatment VAT payments, which are the groups from which we drew the sample of "similar firms" to calculate  $p_i$  and  $\theta_i$ . Including these controls ensures that we only exploit the exogenous variation in  $p_i$  and  $\theta_i$ , that is, the heterogeneity due to sampling variation.  $Post_t$  is a dummy variable that takes the value one if the observation

<sup>57</sup>These results are based on the same specification used for Table 2, except for the addition of dummies for the quintiles of pretreatment VAT payments as additional controls. On that basis we drew the sample to calculate  $p_i$  and  $\theta_i$ .

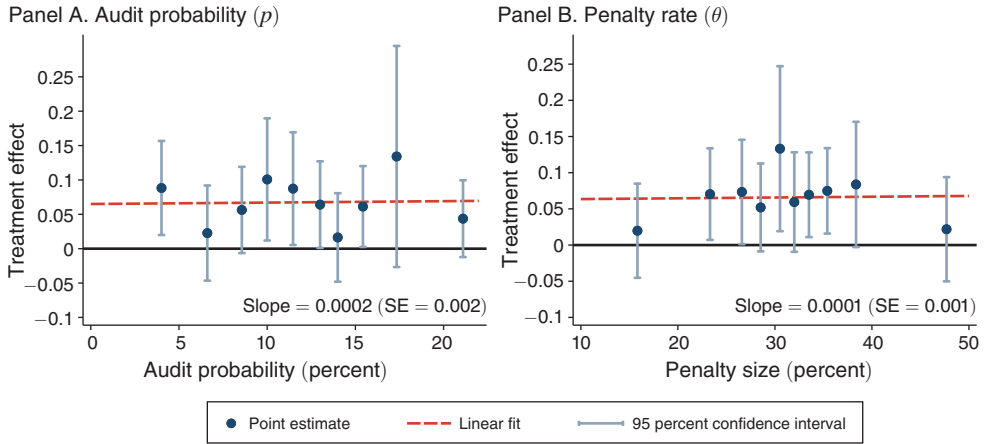


FIGURE 6. EFFECT OF AUDIT-STATISTICS VERSUS BASELINE BY DECILES OF  $p$  AND  $\theta$

Notes: Panel A plots the effect of the audit-statistics letter on total VAT payments by decile of  $p$  in the first year posttreatment (October 2015–September 2016), while panel B reports the results from the same regressions by decile of  $\theta$  (Observations = 10,272). In both panels each dot represents the estimated treatment effect for each decile of the parameter considered. These effects are estimated using a regression similar to the one reported in equation (1) but with two differences. First, instead of including a single treatment variable, we include ten dummy variables, one for each decile of  $p$  or  $\theta$ . These dummies take the value of one if the signal in the letter belongs to the corresponding decile in the  $p$  or  $\theta$  distribution and zero if the signal corresponds to a different decile or if the firm was assigned to the baseline treatment. Second, we include an additional set of dummies for quintiles of the pretreatment VAT payments, which are the groups from which we drew the sample of “similar firms” to calculate  $p$  and  $\theta$  and the corresponding interactions with the posttreatment indicator. All effects are depicted with a 95 percent confidence interval. The results are based on Poisson regressions, so the coefficients can be interpreted directly as semielasticities. Confidence intervals are computed with standard errors clustered at the firm level. The dashed line represents the linear fit that results from regressing the treatment effect on the average signal within the decile.

corresponds to the postexperiment period and zero otherwise. Since we are using a Poisson regression model,  $\gamma_p$  and  $\gamma_\theta$  can be directly interpreted as elasticities. For instance, an estimate of  $\gamma_p = 1$  would imply that a 1 percentage point increase in the audit probability conveyed in the letters increased VAT payments by 1 percent. AS predicts that  $\gamma_p > 0$  and  $\gamma_\theta > 0$ : i.e., that firms’ tax payments increase as their perceived probability of audit and rate of evasion penalty increase.

Panel A in Table 3 presents the results from the econometric model of equation (2). Column 1 of Table 3 presents estimates of the elasticities of VAT payments with respect to the values of  $p$  and  $\theta$  conveyed in the audit-statistics sub-treatments. The elasticity with respect to the audit probability in the first posttreatment year is  $-0.063$  ( $p$ -value = 0.796). This means that increasing  $p$  by 1 percentage point would decrease VAT payments by a mere 0.063 percent. The elasticity with respect to the penalty rate is  $-0.033$  ( $p$ -value = 0.782), which implies that increasing  $\theta$  by 1 percentage point would decrease VAT payments by 0.033 percent. The estimates are close to zero, statistically insignificant at standard levels, and precisely estimated. The degree of precision means that we can rule out even moderate elasticities: the 95 percent confidence interval for the audit probability excludes elasticities above 0.411, and the 95 percent confidence interval for the penalty rate excludes elasticities above 0.198.

TABLE 3—ELASTICITIES OF TAX PAYMENTS WITH RESPECT TO AUDIT PROBABILITY AND PENALTY RATE, AUDIT-STATISTICS AND AUDIT-THREAT SUBTREATMENTS

	By time horizon		By payment timing		By tax type	
	First year (1)	Second year (2)	Retroactive (3)	Concurrent (4)	Non-VAT (5)	VAT + non-VAT (6)
<i>Panel A. Audit-statistics (10,272 firms)</i>						
Audit probability (percent)						
Posttreatment	−0.063 (0.242)	0.076 (0.232)	0.009 (1.103)	−0.040 (0.249)	0.109 (0.240)	0.038 (0.208)
Pretreatment	0.141 (0.164)	0.018 (0.203)	−1.709 (1.118)	0.229 (0.162)	−0.035 (0.230)	0.063 (0.147)
Penalty size (percent)						
Posttreatment	−0.033 (0.118)	−0.175 (0.134)	0.928 (0.763)	−0.098 (0.114)	0.061 (0.103)	−0.001 (0.092)
Pretreatment	−0.128 (0.108)	−0.163 (0.127)	0.204 (0.524)	−0.145 (0.111)	0.018 (0.119)	−0.078 (0.087)
<i>Panel B. Audit-threat (4,048 firms)</i>						
Audit probability (percent)						
Posttreatment	0.217 (0.142)	0.250 (0.175)	−0.347 (0.676)	0.205 (0.209)	0.002 (0.176)	0.233 (0.111)
Pretreatment	−0.185 (0.157)	−0.193 (0.171)	−0.432 (0.676)	−0.149 (0.125)	−0.067 (0.148)	−0.257 (0.164)

*Notes:* Standard errors reported in parentheses are clustered at the firm level. Treatment effects are estimated using the difference-in-difference specification reported in equation (2), which compares treated firms that received different signals on  $p$  and  $\theta$ . In all cases we include an additional set of dummies for quintiles of the pretreatment VAT payments, which are the groups from which we drew the sample of “similar firms” to calculate  $p$  and  $\theta$  and the corresponding interactions with the time variable. The results are based on Poisson regressions with variables expressed in percentage terms, so the coefficients can be interpreted directly as elasticities. Panel A presents the effect of providing different information regarding  $p$  and  $\theta$  in the audit-statistics message. Panel B compares the two audit-threat messages, i.e., the 50 percent threat of audit versus the 25 percent threat of audit. For example, rows 1 and 3 of panel A present the effect of an additional percentage point of  $p$  and  $\theta$  (respectively) in the information included in the letters on posttreatment VAT payments. In the “Posttreatment” rows the coefficient reported corresponds to a comparison of a posttreatment period and a pretreatment period. In the “Pretreatment” rows we present a falsification test where two pretreatment periods are compared. Columns 1 and 2 report the effect of treatment by time horizon. The posttreatment effect reported in column 1 corresponds to the difference-in-difference estimate that compares October 2015–September 2016 to October 2014–September 2015. The posttreatment effect reported in column 2 is analogous but uses the second year after the treatment as the posttreatment period (i.e., October 2016–September 2017). For the falsification tests, column 1 is based on a comparison between October 2014–September 2015 and October 2013–September 2014, while column 2 compares October 2014–September 2015 to October 2012–September 2013. Columns 3 and 4 present the first-year effect of treatment on retroactive and concurrent VAT payments. Columns 5 and 6 report the first-year results by type of tax. Column 5 presents the effect of the treatment on other (non-VAT) tax payments, while column 6 reports the effect on the total amount of taxes paid by the firms during the same period. In all cases we restrict the analysis to firms that effectively received the letter as reported by the postal service.

Significantly, the pretreatment falsification test does not yield any statistically significant effects, and the results are similar for the other specifications, for example, for the second posttreatment year (column 2), by payment timing (columns 3 and 4), and by type of tax (columns 5 and 6). The estimates in all cases are close to zero, precisely estimated, and statistically insignificant.

One potential confounding factor for the lack of heterogeneity in signals on  $p$  and  $\theta$  is that some subjects might have interpreted the audit-statistics message per se as a signal that their firms were on the IRS’s radar, above and beyond the factual information conveyed in the message. We were careful to mitigate this concern in the design



of our mailings by, for instance, underscoring in the letter that its recipients were randomly selected. Nevertheless, some individuals may have ignored or overlooked this cue. While recipients may have learned—or thought they learned—something from the receipt of the audit-statistics message, there is no reason why they could not also learn from the content of the message. In other words, the test presented above continues to be valid, and AS would still predict that the audit-statistics message has a differential effect depending on the values of  $p$  and  $\theta$ .

To address this concern more directly, we use the audit-threat treatment arm, where an explicit threat from the tax agency was made to every recipient. Panel D of Figure 4 depicts the difference in the evolution of VAT payments over time between the two subtreatments in the audit-threat arm, corresponding to audit probabilities of 50 percent and 25 percent. We find almost no systematic difference between the two groups in posttreatment VAT payments. We can perform a more parametric test based on an econometric model similar to the one in equation (2) for firms assigned to the audit-threat letter:

$$(3) \quad Y_{it} = \alpha + \tau_p \cdot p_i + \delta \cdot Post_t + \gamma_p \cdot p_i \cdot Post_t + \epsilon_{it},$$

where  $p_i \in \{0.25, 0.50\}$  is the audit probability in the audit-threat letter sent to firm  $i$ . Again, AS predicts  $\gamma_p > 0$ . The results are presented in panel B of Table 3. While the estimated coefficient based on audit-threat messages implies an elasticity of 0.217 with respect to  $p$  in the first year posttreatment, this estimate is economically small and statistically insignificant ( $p$ -value = 0.128). Taking into account precision and power concerns, the evidence from panel D of Figure 4 and panel B of Table 3 further reinforces our result. Contrary to AS predictions, tax compliance does not seem to depend on the probability of being audited, even when there is a direct and credible threat of an audit, rather than simply information on audit probabilities.

The evidence is robust, then, that firms did not react to the values of  $p$  and  $\theta$  shown in our letters.<sup>58</sup> Since a large portion of our subject pool was assigned this treatment arm, these elasticities are precisely estimated. It is not clear, however, whether the estimates are small enough, and precisely estimated enough, to rule out the values of the elasticities predicted by AS. We address this question below.

*AS Calibration.*—For a quantitative test of AS, we need quantitative predictions from AS. In this section we present results from different calibrations of the model and compare them to the experimental results in the following section.

Let  $Y$  be the total value-added amount, and let  $\tau = 0.22$  be the value-added tax rate. Let  $E$  be the amount to be underreported (so  $\tau \cdot E$  is the amount evaded). Each firm has a utility from income given by a Constant Relative Risk Aversion (CRRA) utility function with risk parameter  $\sigma$ . Let  $p$  be the probability that the tax return for a given year be audited sometime in the future and  $\theta$  the penalty rate applied

<sup>58</sup> See online Appendix B.6.2 for a series of robustness checks (alternative specifications based on OLS, Tobit and Probit models, and using an alternative data source for the dependent variable), all of which yielded similar results. An additional robustness check, presented in the same Appendix, shows that results are robust if, instead of estimating elasticities with respect to  $p$  and  $\theta$  separately, we estimate elasticity with respect to  $p \times \theta$  (i.e., the expected penalty per dollar evaded).

over the amount evaded when caught (both of these parameters are defined as in the audit-statistics treatment).

Given any reasonable value for the CRRA parameter, the basic AS model predicts 100 percent evasion. As a result, we need to use one of the extensions discussed in the literature to accommodate the 26 percent evasion rate observed in practice (as estimated by Gómez Sabaini and Jiménez 2012). We consider the following extensions: endogenous audit probabilities (Allingham and Sandmo 1972; Yitzhaki 1987), third-party reporting and whistle-blowing (Acemoglu and Jackson 2017), misperceptions of audit parameters (Alm, McClelland, and Schulze 1992), and social preferences (Luttmer and Singhal 2014).

The probability of being audited can be broken down as  $p = p_0 + p_1 \frac{E}{Y}$ .<sup>59</sup> The parameter  $p_1 > 0$  represents the endogeneity of the audit process, whereby firms that evade more are more likely to be audited (in the original AS model, the audit probability is exogenous so  $p_1 = 0$ ). Firms can be caught evading by some nonaudit technology such as third-party reporting or whistle-blowing. We represent this with an effective probability of being caught of  $p + \epsilon$ , where the parameter epsilon represents the additional monitoring tool. To allow for misperceptions, we can calibrate  $p$  and  $\theta$  to the average perceptions reported in the survey rather than the values calculated on the basis of the tax agency's administrative records. To allow for social preferences, we assume that individuals get some direct utility from paying taxes and that utility is equal to the fraction  $\alpha$  of the amount paid. This social responsibility parameter  $\alpha$  can take values from zero to one, where a higher value denotes a greater sense of social responsibility (in the original AS,  $\alpha = 0$ ).

The optimal evasion choice is given by maximizing the expected utility:

$$(4) \quad \max_{E \in [0, Y]} \frac{1 - p\left(\frac{E}{Y}\right) - \epsilon}{1 - \sigma} (Y - \alpha\tau(Y - E))^{1-\sigma} + \frac{p\left(\frac{E}{Y}\right) + \epsilon}{1 - \sigma} (Y - \alpha\tau(Y - E) - (1 + \theta)\tau E)^{1-\sigma}.$$

Given a set of parameters, it is straightforward to find the optimal value of  $E$  that solves this maximization problem.<sup>60</sup> Table 4 presents the calibration results; each row corresponds to a different calibration of AS. The first seven columns correspond to the parameter values, while the last three indicate the corresponding predictions:  $\frac{E}{Y}$  is the evasion rate,  $\frac{\partial \log(\tau(Y - E))}{\partial p}$  is the elasticity with respect to the audit probability, and  $\frac{\partial \log(\tau(Y - E))}{\partial \theta}$  is the elasticity with respect to the penalty rate.<sup>61</sup>

All the parameters are calibrated so that the predictions always match the average evasion rate ( $\frac{E}{Y}$ ) of 26 percent (Gómez Sabaini and Jiménez 2012). In the first row we assume a CRRA of four and set the audit probability and penalty rates at the rates

<sup>59</sup>We assume that, when an audit occurs, all evasion is detected. In practice that probability may be smaller than one, which would only make the AS result more puzzling: firms should be even less worried about being audited.

<sup>60</sup>For more details, see online Appendix C.

<sup>61</sup>These two elasticities are defined exactly as in the econometric model from equations (2) and (3) to facilitate the comparison of the regression results and the calibrations.

TABLE 4—PREDICTED ELASTICITIES UNDER DIFFERENT AS CALIBRATIONS

$\sigma$	Setup						Predictions		
	$\tau$	$p_0$	$p_1$	$\epsilon$	$\theta$	$\alpha$	$\frac{E}{Y}$	$\frac{\partial \log(\tau(Y-E))}{\partial p}$	$\frac{\partial \log(\tau(Y-E))}{\partial \theta}$
4	0.220	0.117	0.000	0.575	0.306	1.000	0.260	4.516	3.434
4	0.220	0.117	0.000	0.000	0.306	0.202	0.260	9.116	1.207
4	0.220	0.0896	0.0896	0.000	0.306	0.2296	0.260	3.324	0.589
4	0.220	0.407	0.000	0.000	0.305	0.643	0.260	3.889	1.763
2	0.220	0.117	0.000	0.614	0.306	1.000	0.260	9.777	6.578
2	0.220	0.117	0.000	0.000	0.306	0.176	0.260	18.245	2.111
2	0.220	0.0896	0.0896	0.000	0.306	0.2022	0.260	4.215	0.661
2	0.220	0.407	0.000	0.000	0.305	0.586	0.260	7.771	3.030

Notes: Each row corresponds to a different calibration of the extended AS model presented in Section IVB. The first seven columns correspond to the parameter values. The last three columns correspond to the predictions of the model under those parameter values. The predicted evasion rate ( $\frac{E}{Y}$ ) is always 26 percent because all the specifications were calibrated to match that rate.

estimated from administrative records ( $p_0 = 0.117$  and  $\theta = 0.306$ ). To match the 26 percent evasion rate, we allow for a nonaudit detection rate of  $\epsilon = 0.575$ . The resulting elasticity is 4.516 with respect to  $p$  and 3.434 with respect to  $\theta$ . This is the simplest extension to the AS model, and given that its predictions are in the middle range of all our calibrations, it is our preferred specification. The remaining rows present results with alternative calibrations of the model. Even though the models are quite different, the predicted elasticities are in the same order of magnitude as our preferred specification.

In the second row instead of accommodating the evasion rate of 26 percent by introducing the nonaudit detection rate, we assume a social responsibility parameter of  $\alpha = 0.202$ . While this different approach yields different predicted elasticities, they are in the same order of magnitude: the elasticity with respect to the audit probability is 9.116, and the elasticity with respect to the penalty rate is 1.207. The specification in the third row is similar to the one in the second row, but it is augmented by allowing for an endogenous audit probability. We let  $p_0 = p_1 = 0.0896$ , which accommodates two important features of audit probabilities: the effective audit probability turns out to be equal to the observed average probability of 11.7 percent, and, consistent with the content of the audit-endogeneity message, a firm that does not evade taxes ( $\frac{E}{Y} = 0$ ) would double its audit probability if it decided to evade taxes ( $\frac{E}{Y} = 1$ ). Since this endogeneity parameter is not, on its own, enough to match the observed evasion rate, we again rely on the social responsibility parameter by setting  $\alpha = 0.2296$ . This specification shows that introducing endogeneity to the audit probabilities barely changes elasticity with respect to the audit probability (it is 3.324, similar to the 4.516 from the first specification), but it does substantially reduce elasticity with respect to the penalty rate (to 0.589). The fourth row follows a similar specification as the second row but is extended by allowing individuals to have biased perceptions of the audits:  $p_0 = 0.407$  and  $\theta = 0.305$ . These biases would not, on their own, be enough to match the observed evasion rate, so we set the social responsibility parameter to  $\alpha = 0.643$ . The elasticities yielded are, once again, of the same order of magnitude as with the other specifications: the elasticity is 3.889 with respect to audit probability and 1.763 with respect to the penalty rate.

The specifications in the second set of four rows are identical to the ones in the first set of four rows, except the assumption of a CRRA of two instead of four. The results indicate that assuming a lower level of risk aversion leads to elasticities that are even larger in magnitude.

*Comparison of Experimental Results and the AS Calibration.*—We can test the null hypothesis that the elasticities for  $p$  and  $\theta$  in the main specification of the audit-statistics presented in column 1 of Table 3 ( $\gamma_p = -0.063$  and  $\gamma_\theta = -0.033$ ) are equal to the elasticities in our preferred AS calibration. We can reject the null hypothesis that the elasticity is 4.516 for the audit probability and 3.434 for the penalty rate (both tests with  $p$ -values  $< 0.001$ ). In other words, the calibrated elasticities (4.516 for the audit probability and 3.434 for the penalty rate) far exceed the 95 percent confidence bands for the estimated elasticities ( $[-0.536, 0.411]$  and  $\gamma_\theta[-0.264, 0.198]$ , respectively).

One potential concern with the above comparison is the implicit assumption that a letter conveying the message of a 1 percentage point higher signal of  $p$  or  $\theta$  will increase the recipient's perception of the parameter by 1 percentage point—and that is a lot to assume: some taxpayers may not have adjusted their prior belief all the way to the signal, and other taxpayers may not have even read the letter in the first place. As a benchmark, we can use the estimates from related studies that measure how individuals learn about economic variables such as the inflation rate (Cavallo, Cruces, and Perez-Truglia 2017), cost of living (Bottan and Perez-Truglia 2022), and housing prices (Fuster et al. 2022). These studies find that for each percentage point increase in the feedback given to subjects, the average individual alters their beliefs by about half a percentage point. If we assume this rate of learning, we should double the elasticities estimated in our regressions before comparing them to the calibrations of AS. Even under this assumption, we could still confidently reject the null hypothesis that the estimated elasticities are equal to the calibrated elasticities ( $p$ -values  $< 0.001$  for both  $\gamma_p$  and  $\gamma_\theta$ ).

The effect of the differential values of  $p$  and  $\theta$  on the audit-statistics treatments, presented in Section IVA, can provide a direct estimate of the learning rate in our context. The survey data suggest that a 1 percentage point increase in the signal on audit probability in the letter increased the perceived audit probability 9 months later by 0.397 percentage points (SE 0.288). Even if it is imprecisely estimated and thus statistically insignificant at conventional levels, this point estimate suggests a learning rate consistent with other studies of learning, which is reassuring. Moreover, because of multiple sources of noncompliance, that rate is probably less than the true learning rate.<sup>62</sup> We can, furthermore, reproduce the analysis with an extremely conservative assumption on the magnitude of the learning rate: even if we assumed that for each percentage point difference in the letter individuals adjusted their beliefs by only one-tenth of a percentage point, the null hypothesis that the estimated elasticities are equal to those in the AS calibration ( $p$ -values of 0.033 and 0.002 for audit probability and for penalty rate, respectively) could be rejected.

<sup>62</sup>For a discussion of the sources of noncompliance, see footnote 55.

*Comparison to Related Studies.*—We can also compare our estimated elasticities to those from related studies. In some research laboratory experiments are used to study tax evasion. These experiments often randomize the probability of being audited by experimenter and penalties involved. Consistent with our results, those laboratory studies find evidence of probability neglect. For example, Alm, Jackson, and McKee (1992) find an elasticity of 0.169 with respect to audit probability (comparable to our estimate of  $-0.063$ ), and an elasticity of 0.037 with respect to penalty rate (comparable to our estimate of  $-0.033$ ). Indeed, these elasticities are statistically indistinguishable from the ones obtained in our study ( $p$ -values of the differences are 0.338 and 0.555, respectively).

We also compare our findings to the results of a couple of related field experiments. Dwenger et al. (2016) conducted a field experiment in the context of a local church tax in Germany for which enforcement was extremely lax. While this experiment was not designed to test the AS model, it did include one treatment arm where the message mentioned different audit probabilities ( $p = 0.1$ ,  $p = 0.2$ , or  $p = 0.5$ ). The results are qualitatively consistent with our finding of probability neglect: the effects of all these probability messages are statistically indistinguishable from each other. Another related experiment, Kleven et al. (2011), included a treatment arm with two different audit probabilities. Consistent with our results, it finds rates of tax compliance between individuals assigned to different audit probabilities to be negligible in magnitude.<sup>63</sup> The evidence from Kleven et al. (2011), however, would be consistent with AS because their subjects face automatic third-party reporting, which our subjects do not. The authors conducted their experiment with wage earners in a country where tax evasion is automatically detected through third-party reporting, regardless of audits. As a result, AS predicts that, consistent with their evidence, wage earners would report their earnings truthfully regardless of probability of being audited.

## V. Discussion: Risk-as-Feelings

In this section we summarize our findings and discuss their potential interpretations and implications.

We present three main findings. First, we documented *increased compliance*: on average, the audit-statistics message had a positive effect on tax compliance. Second, we reported *reduced subjective probability*: on average, the audit-statistics message decreased the perceived probability of being audited. Third, we documented *probability neglect*: the effect of the audit-statistics message did not depend on the audit probability conveyed in the letter or on the firm's prior belief about that probability. Jointly, these three findings are inconsistent with the AS predictions. But the question of what framework might provide a better fit for these results remains unanswered.

<sup>63</sup>In one of their treatments, they send letters to individuals stating audit probabilities as high as  $p = 50\%$  and  $p = 100\%$ . Compared with a group that did not receive any letter, they find that the letters had a positive and significant effect on declared income and tax liability. While statistically significant, the differential effect between these two groups is economically negligible: an increase from 50 percent to 100 percent in the signal on the probability of audit increases reported income by 0.025 percent and taxes paid by 0.05 percent.

One natural candidate is salience (Chetty, Looney, and Kroft 2009): firms may behave as if the probability of detection and the penalty rate were zero unless those parameters are made salient to them. This explanation could reconcile the findings of increased compliance and reduced perceived audit probability: even if firms who were sent the messages adjusted downward their perceived probability of audit, they would have behaved as if that probability were zero had they not received those signals. However, the salience model fails to explain other features of our findings. First, salience effects are by definition short-lived. A reminder of a nonsalient tax should only affect the behavior of an agent at the time the information is received, not days or months later. Effectively, salience models predict a rapid decay of the effect of information, which contradicts our evidence that the audit-statistics letter had effects that persisted months after the information was transmitted.<sup>64</sup> The salience model is also inconsistent with our finding of probability neglect: according to that model, the effect of making salient a high audit probability should be greater than the effect of making salient a low audit probability.<sup>65</sup>

A second explanation would be agency issues at the firm if, say, the person who received the letter was not the person who decided how much tax to evade. This type of agency issue would generate insensitivity to the information received (or, at least, an attenuation effect). We find, however, that firms do react to the information received, just not in the direction predicted by AS (i.e., information on low audit probabilities reduces, rather than increases, evasion). Moreover, agency and information frictions should be weaker in smaller firms, and the firms in our experimental sample are small: over 75 percent of firms in our sample have 5 or fewer employees.<sup>66</sup> Moreover, the heterogeneity analysis indicates no substantial or statistically significant difference between firms below and above the median number of employees (one to three employees versus the rest), which further reinforces the point that agency issues are not a decisive factor in our context.<sup>67</sup>

Our preferred interpretation is based on the model of risk-as-feelings (Loewenstein et al. 2001). The traditional economic models used for choice under uncertainty are cognitive in that agents make decisions using some sort of expectation-based calculus. The risk-as-feelings model proposes that responses to fearsome situations may differ substantially from cognitive evaluations of the same situations (Loewenstein and Lerner 2003).<sup>68</sup> When fear is involved, agents tend to neglect the cost-benefit

<sup>64</sup>The informational treatment may increase salience and cause an instantaneous effect with lasting consequences if, for instance, it induces a change in the way the firm deals with evasion in transactions. Such a change would imply a constant effect over time, however, and we find a substantial decline in evasion over the year following the intervention.

<sup>65</sup>Another pertinent model from behavioral economics is prospect theory (Kahneman and Tversky 1979; see, for example, Dhali and al-Nowaihi 2007). This model, however, is unlikely to explain our findings on, for instance, probability neglect: although differences between extremely low probabilities can be ignored under prospect theory, the range of probabilities in our context (e.g., in the audit-threat arm, the probabilities were 25 percent versus 50 percent) was far higher than what is normally considered extremely low in prospect theory.

<sup>66</sup>More precisely, 29.1 percent of the firms have a single employee, 46.2 percent have between 2 and 5 employees, and 15 percent have between 6 and 10 employees.

<sup>67</sup>See online Appendix B.8.

<sup>68</sup>A related concept, the affect heuristic, corresponds to quick, automatic, and intuitive evaluations of risky situations based on emotions, which might be used as a shortcut for more complex evaluations of risk (Slovic et al. 2004). Borrowing Kahneman's (2003) terminology for the dual system model of the human mind, emotions might influence the intuitive system.



calculus and instead have quick, automatic, and intuitive responses to risk. A key prediction of this model is that feelings about risk are largely insensitive to changes in probability, in what the literature calls probability neglect (Sunstein 2002; Sunstein and Zeckhauser 2010). According to this model, the emotional response to risk makes individuals ignore the underlying likelihoods. There is evidence of probability neglect in a range of fearsome situations involving electric shocks, arsenic, abandoned hazardous waste dumps, pesticides, and anthrax (Sunstein 2003; Sunstein and Zeckhauser 2010).

This risk-as-feelings model can reconcile our three key findings, namely increased compliance and reduced subjective probability: even if the perceived probability of audit decreased among the treated subjects, they may nonetheless be scared into paying more taxes because they did not rely on cognitive evaluations of probabilities. The risk-as-feelings model predicts probability neglect and thus fits our third finding too.

The risk-as-feeling model suggests that taxpayers overreact to the threat of audits.<sup>69</sup> This interpretation can explain the paradox that, despite low audit probabilities and penalty rates, most taxpayers report the threat of audits as a major reason for reporting taxable income truthfully. For example, a survey by the United States Internal Revenue Service (2017) indicates that 61 percent of US taxpayers claim that a “fear of audits” exerts a significant influence on their tax compliance decisions.<sup>70</sup> In comparison, audits are perceived as as strong a deterrent as third-party reporting: 66 percent of respondents identified “third-party reporting (e.g., wages, interest, dividends)” as an important factor for tax compliance. Moreover, there is some direct evidence that, consistent with the risk-as-feelings model, taxpayers have an emotional reaction to the thought of tax audits and the tax authority more generally. Some of the evidence comes from laboratory experiments. Coricelli et al. (2010), for instance, conducted a tax evasion game in the laboratory and measured how emotional arousal affected tax evasion decisions. They showed that the intensity of emotional arousal predicts whether and how much individuals evade. In a related laboratory study, Dulleck et al. (2016) showed a significant correlation between tax compliance and physiological markers of stress in making decisions about tax filing. Fear of tax audits can also be found in the media. For example, a *Washington Post* article claims that “a lot of people are super scared of the Internal Revenue Service” and that its powers “can instill a lot of fear” (Singletary 2016). The *New York Times* reported cases where fear of the tax authority is strong enough to be considered a phobia (Delafuente 2009).

In other areas of public policy, the risk-as-feelings heuristic can be a problem. It distorts facts and leads to irrational judgment, which results in suboptimal decisions from a pure risk-assessment perspective. Sunstein and Zeckhauser (2010) and others discuss cases involving regulation of nuclear power, vaccines, and other heated

<sup>69</sup>This excessive caution has been documented in other contexts (Loewenstein et al. 2001). A fear of terrorist attacks, for instance, can make people choose not to take airplanes but rather other, more dangerous, forms of transport, and a fear of shark attacks can lead to unnecessary legislation (Sunstein 2002, 2003; Sunstein and Zeckhauser 2010).

<sup>70</sup>More precisely, 32 percent of respondents claim that a “fear of audits” exerts “a great deal of an influence,” and 29 percent “somewhat of an influence” on whether they honestly report and pay their taxes.



emotional issues. When it comes to tax collection, such behavioral biases might have positive implications for the tax authority's goals. Indeed, there is anecdotal evidence that tax authorities use fear tactics to foster tax compliance. In the United States, for example, a disproportionately large number of tax enforcement press releases covering criminal convictions and civil injunctions are released during the weeks immediately preceding Tax Day, presumably to scare taxpayers into preparing compliant returns (Morse 2009; Blank and Levin 2010). Some tax experts even claim that the IRS "likes [targeting] celebrities because they get the most bang for their buck in terms of publicity" to "scare the public into complying" (Wingfield 2008).

The risk-as-feelings framework indicates that vivid imagery can be used to instill fear and biased risk evaluations (Slovic et al. 2004; Sunstein and Zeckhauser 2010). Coincidentally, tax agencies seem to resort to vivid images in some of their advertising campaigns. A TV advertisement in the United States showed the IRS as "something like poltergeist coming out of a TV set and the world falling apart," followed by the phrase, "Have you filed your income tax?" (Giuffre 1988). The UK tax agency used advertisement campaigns that also rely on frightening imagery. One poster features a pair of eyes peeking threateningly through a gash in a piece of paper that reads, "If you've declared all your income, you have nothing to fear."<sup>71</sup> This anecdotal evidence suggests that some tax administrations may be leveraging fear to help in collecting taxes.<sup>72</sup>

## VI. Conclusions

The canonical model Allingham and Sandmo (1972) predicts that firms evade taxes by making optimal trade-offs on the costs and benefits of evasion. It is unclear, however, whether real-world firms react to audits according to that model. We designed a large-scale field experiment in collaboration with Uruguay's tax authority to assess the factors behind firms' evasion behavior and reactions to audits. Our findings indicate that firms do increase tax compliance when informed of the audit process. We do not, however, find this reaction to be consistent with the predictions of AS. For example, the information on audits decreased (rather than increased) the perceived probability of being audited; moreover, the effects of our messages about audit probabilities were independent from the signal we conveyed and from the firms' prior beliefs. Models of salience are consistent with the increased compliance and reduced perceived perception of audit probabilities that we observed, but they are not consistent with our findings on probability neglect. All three findings can, we agree, be reconciled by the risk-as-feelings model, which heeds the role of emotions in decision-making and predicts that agents tend to exhibit probability neglect in dreaded or feared situations, like paying taxes.

<sup>71</sup> This poster is reproduced in online Appendix D.

<sup>72</sup> Whether these fear tactics should be used by tax agencies is outside the scope of this paper. These tactics may be ethically questionable to the extent to which they rely on deception. Moreover, actively promoting fear could have unintended negative effects, such as imposing negative psychological stress on taxpayers. For a discussion of the ethical and practical issues at stake in communication efforts to increase tax compliance, see, for example, Morse (2009).

Our findings also contribute to the more general debate on the determinants of tax compliance. One of the main puzzles in the literature is overly low evasion rates. Third-party reporting can explain high levels of compliance for some sources of income, such as wage income (Kleven et al. 2011). We would expect, however, much higher evasion rates in other contexts, such as for self-employed income, where there is limited third-party reporting and low detection probabilities and penalty rates. One traditional explanation for this phenomenon is tax morale: firms and individuals do not evade taxes because complying with tax obligations is the right thing to do (Luttmer and Singhal 2014). Our evidence suggests an alternative explanation: because tax decisions are emotional, audits scare taxpayers into compliance just as scarecrows scare birds.

We conclude by discussing some policy implications. In the traditional AS framework, the relevant policy lever is the number of audits: the tax agency must find the point at which the marginal cost of an additional audit equals the expected marginal benefit (i.e., higher tax revenues). Our findings suggest that small and medium-sized firms face significant information and optimization frictions when reacting to audits. These frictions introduce new levers for policymaking. Tax agencies can, for instance, decide whether to be transparent about the audit process,<sup>73</sup> whether to contact taxpayers to remind them of it, and whether to make the costs of being a tax cheat salient and vivid through advertisement campaigns.<sup>74</sup> There is anecdotal evidence that some tax agencies already have working knowledge of these policy levers. Some tax agencies seem to avoid transparency about the auditing process while increasing the visibility of enforcement actions around tax day. Some even make direct reference to fear in their advertisement campaigns. There is no direct evidence, though, on whether these policies effectively increase tax compliance or whether they have unintended effects, such as instigating so much fear in taxpayers that their anxiety and unhappiness trump the positive effects of increased tax revenues. As stated by Alm (2019, 16) in a recent review of the literature, “the role of emotions in tax compliance decisions remains largely unexamined.” Our results highlight the need for more research on probability neglect in the decision to comply with tax obligations. Additional research should examine the role emotions play on other important economic choices, not only tax compliance.

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<sup>73</sup>On the one hand, our evidence indicates that increasing transparency about audit probability will reduce the average perceived probability of being audited, which could reduce tax compliance. On the other, our finding of probability neglect suggests that, in the end, the reduction in perceived audit probability may not affect tax compliance.

<sup>74</sup>For a practical discussion of how to implement this type of policy, and the drawbacks, see Morse (2009). This same principle can be used to increase compliance with other laws. Dur and Vollaard (2019) provide experimental evidence to show that the salience of law enforcement can be used to reduce illegal garbage disposal, for instance.

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