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TESTING THE MODELS OF TAX COMPLIANCE: THE USE-TAX EXPERIMENT

Adam B. Thimmesch*

Abstract

Researchers in a number of fields have explored the question of why people voluntarily comply with the tax laws. The resulting scholarship suggests that a number of factors influence that decision, but the precise role of, and interaction between, those factors continue to be subjects of debate. More research is thus needed, including field research to put the current theories to test in real-life settings. This Article proposes that state use taxes—known primarily as the taxes that are due when taxpayers purchase items online without paying sales taxes—provide a remarkable opportunity for that research. Compliance with those taxes is virtually nonexistent, and most discussions of that issue simply assume that obtaining meaningful levels of voluntary compliance will be impossible. Those assumptions are largely based on rudimentary applications of a basic deterrence model, which relies heavily on audit risk and penalties as motivators of compliance. The modern models of tax compliance, however, offer many different theories with which states could experiment to promote the voluntary payment of those taxes. That experimentation would not only help states to increase their tax collections, but would also help states and researchers to obtain a deeper understanding of the very models being applied. The lessons learned from those efforts could thus help to inform researchers, the federal government, and governments worldwide regarding how to best encourage voluntary compliance with tax laws more generally. This Article begins the process of obtaining those reciprocal benefits by summarizing the current models of tax compliance and by offering concrete examples of how states could use those models within the context of their use-tax systems. The Article concludes by exploring the features of state use taxes that make them especially well suited for these efforts.

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I. INTRODUCTION

Modern compliance theories suggest that a number of factors influence an individual's decision of whether to comply with the law. Traditional economic or deterrence theories assert that the decision to comply depends on a cost-benefit or expected-utility analysis. Compliance under that model largely depends on the existing penalties for noncompliance and a person's perceived likelihood of that malfeasance being discovered. Other models rely on psychological or sociological factors that impact compliance, like social norms or perceptions of equity. Behavioral sciences question the assumption of rationality that has underscored much of our understanding of the deterrence model, and governments worldwide are evaluating how behavioral factors influence citizen behavior as well.¹

Legal scholars have applied lessons from this research to suggest a number of modifications to how our nation's tax laws are structured and administered. The resulting scholarship addresses topics including the impacts of third-party reporting on tax compliance,² the use of procedural-justice considerations in tax enforcement,³ the impact of nontax consequences on reporting behavior,⁴ and the behavioral factors that tax authorities can use to increase compliance.⁵ In all, however, the

¹ See *infra* Part II.B.3 (discussing government attention to behavioral sciences in the United Kingdom and in the United States).

² Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 *FORDHAM L. REV.* 1733, 1736 (2010) [hereinafter Lederman, *Information Gaps*]; Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 *STAN. L. REV.* 695, 697 (2007) [hereinafter Lederman, *Speed Bumps*].

³ See, e.g., Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 *FLA. TAX REV.* 599, 622–31 (2007) (discussing tax morale and procedural justice as motivators of tax compliance); Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 *U. KAN. L. REV.* 971, 996–1008 (2003) [hereinafter Lederman, *Tax Compliance*] (discussing research on how the perceived fairness of IRS procedures may increase tax compliance); Stephen W. Mazza, *Taxpayer Privacy and Tax Compliance*, 51 *U. KAN. L. REV.* 1065, 1071–73 (2003) (discussing study results showing that “individuals’ perceptions of procedural fairness in their dealings with decision makers have a positive impact on compliance with legal obligations”); Leigh Osofsky, *Some Realism About Responsive Tax Administration*, 66 *TAX L. REV.* 121, 126–30, 140–43 (2012) (evaluating the procedural-justice literature and concluding that it is uncertain if procedural justice increases compliance).

⁴ See generally Joshua D. Blank, *Collateral Compliance*, 162 *U. PA. L. REV.* 719 (2014).

⁵ See, e.g., *id.* at 745–55 (analyzing the behavioral aspects of tax compliance); Joshua D. Blank, *In Defense of Individual Tax Privacy*, 61 *EMORY L.J.* 265, 287–326 (2011) (focusing on the “interaction between tax privacy and specific examples of tax enforcement . . . motivated by behavioral research”); Sarah B. Lawsky, *Modeling Uncertainty in Tax Law*, 65 *STAN. L. REV.* 241, 257–73 (2013) (introducing a model that takes into account individuals’ responses to uncertainty); Susan Cleary Morse, *Using Salience and Influence to Narrow the Tax Gap*, 40 *LOY. U. CHI. L.J.* 483, 500–03 (2009) (evaluating behavioral

various models of tax compliance establish that taxpayers' decision-making processes are dynamic and multifaceted. The only clear conclusion is that compliance is nearly universal in situations where detection and punishment are practically assured. These include the taxation of wage income, which is subject to information reporting and withholding at the source.⁶

Unfortunately for tax administrators, significant amounts of income do not fall within current information-reporting systems, and the modern economy is shifting in ways that put further stress on those existing systems. From the emergence of virtual currencies like Bitcoin to so-called collaborative consumption services like Uber and Airbnb, technology is decentralizing income generation from traditional sources. That puts stress on the structural mechanisms that have resulted in widespread tax compliance in the United States.⁷ Our incomplete understanding of the motivators of tax compliance will thus be of further consequence in the future, and additional attention to the factors motivating tax compliance is necessary.

This is not a matter of simple academic curiosity. The U.S. federal income tax gap—the difference between the amount of tax reported and the amount of tax owed—has been estimated to be roughly \$450 billion per year.⁸ This is unlikely to improve in the near term. The IRS budget has been reduced sharply in the last several years, and there is no sign that those cuts will be abated.⁹ In the face of this resource shortfall, the federal government will be required to find ways to increase compliance that do not require costly audit activity.

This problem is obviously not unique to the federal government; state governments face similar pressures. That is true with respect to state income taxes—where the underreporting of taxable income to the IRS directly leads to the

compliance research and explaining how the concepts of salience and influence relate); Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489, 499–538 (2011) (discussing taxpayers' potential reactions to strategic uncertainty); Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 TAX L. REV. 111, 129–39 (2013) (evaluating the behavioral impact of presumptive tax payments); Kathleen DeLaney Thomas, *The Psychic Cost of Tax Evasion*, 56 B.C. L. REV. 617, 626–31 (2015) (discussing noneconomic theories of tax compliance).

⁶ 26 U.S.C. §§ 6041, 6051 (2012).

⁷ See Shu-Yi Oei & Diane M. Ring, *Can Sharing Be Taxed?*, 93 U. WA. L. REV. (forthcoming 2016), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2570584###, archived at <http://perma.cc/4BNG-PXPB> (broadly discussing the tax issues, including the compliance issues, raised by the sharing economy).

⁸ I.R.S. News Release IR-2012-4 (Jan. 6, 2012), available at <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>, archived at <http://perma.cc/C7UG-9E2T>.

⁹ Treasury Inspector General for Tax Administration, Ref. No. 2014-30-062, *Trends in Compliance Activities Through Fiscal Year 2013*, at 2 (2013), available at <http://www.treasury.gov/tigta/auditreports/2013reports/201330078fr.pdf>, archived at <http://perma.cc/68ZL-6G8S>.

underreporting of taxable income to states¹⁰—and with respect to state consumption taxes, which do not have a federal counterpart.¹¹ In fact, one such consumption-tax gap has been the subject of significant attention by states and Congress even though it has gone virtually unaddressed by compliance scholars—the use-tax gap.

State use taxes are complementary to state income taxes, and are generally owed when a consumer makes a purchase of a taxable item without paying sales tax. This often occurs, for example, when a consumer purchases an item from an online vendor that does not collect the tax. That result stems directly from the U.S. Supreme Court's determination that states lack the constitutional authority to require vendors to collect their consumption taxes unless the vendors have a physical presence within their boundaries.¹² Congress could override that rule using its affirmative Commerce Clause power, but it has failed to do so.¹³ In the meantime, then, consumers are required to remit the required tax of their own accord.

For reasons largely assumed and unstudied, consumer compliance with state use taxes is virtually nonexistent, and that collective noncompliance is costly. The combination of the lack of tax collection at the point of sale and consumers' noncompliance with the tax is estimated to cost states approximately \$20 billion per year.¹⁴ Notwithstanding those losses, states addressing use taxes have paid little

¹⁰ This is because states generally base their income taxes off of the income that taxpayers report to the IRS. WALTER HELLERSTEIN, *STATE TAXATION* ¶ 20.02 (3d ed. 2012); see also Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 *DUKE L.J.* 1267, 1274–79 (2013) (discussing the policy implications of federal-state tax-base conformity).

¹¹ See DONALD BRUCE ET AL., *STATE AND LOCAL GOVERNMENT SALES TAX REVENUE LOSSES FROM ELECTRONIC COMMERCE 2* (2009), available at <http://cber.bus.utk.edu/ecomm/ecom0409.pdf>, archived at <http://perma.cc/4JLL-AU86> (reporting on the significant sales and use-tax gap attributable to unremitted tax on electronic commerce); CAL. STATE BD. OF EQUALIZATION, *TAX RECOVERY AND CRIMINAL ENFORCEMENT, ADDRESSING THE TAX GAP*, http://www.boe.ca.gov/news/tax_gap.htm, archived at <http://perma.cc/GB67-S9UT> (reporting an estimated state sales and use-tax gap of \$2 billion); ERIC COOK ET AL., *MINNESOTA SALES AND USE TAX GAP PROJECT: FINAL REPORT 1–5* (2002), available at http://www.revenue.state.mn.us/research_stats/research_reports/2002/research_reports_content_taxgap_full_1102.pdf, archived at <http://perma.cc/T8PF-S3YD> (comprehensively analyzing the state's sales and use-tax gap); DENNIS COLLIER & JACK NORMAN, *WISCONSIN'S BILLION-DOLLAR TAX GAP 3* (2010), available at http://wisconsinsfuture.org/wp-content/uploads/2012/08/TAX_GAPApril_2010.pdf, archived at <http://perma.cc/TNP4-L5UV> (noting a state sales-tax gap of \$536 million).

¹² See *infra* Section III.A.

¹³ *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (U.S. 1992) (noting that Congress “has the ultimate power to” overrule the physical-presence rule).

¹⁴ BRUCE ET AL., *supra* note 11, at ii–iii (estimating revenue losses of \$6.8 billion with respect to non-e-commerce remote sales like catalog sales and \$11.4 billion with respect to e-commerce sales). Including the estimated lost revenue due to nonelectronic remote business-to-business commerce takes the estimated annual revenue losses to over \$23 billion. *Collecting E-Commerce Taxes | E-Fairness Legislation*, NAT'L CONF. OF STATE

attention to encouraging voluntary compliance,¹⁵ and scholars researching tax compliance have paid little attention to use taxes. One prominent economist and leading tax-compliance scholar has gone so far as to note that use taxes are “largely unenforceable.”¹⁶ This Article challenges that disconnect. Applying modern tax-compliance theories to state use taxes could increase use-tax compliance while simultaneously providing researchers with important real-world data on those theories.

To be sure, this approach goes against the prevailing assumption that states will be unable to produce meaningful compliance with the tax. At a base level, states simply lack the ability to effectively monitor and enforce their use taxes. For example, a consumer in a state with an 8% sales and use-tax rate who makes \$2,000 of online purchases in a year would owe a maximum of \$160 of tax on those purchases. Allocating enforcement dollars to the tax does not appear to make practical sense given those relatively low liabilities.¹⁷ For these reasons, states have not focused on individual taxpayer compliance, but instead on getting the tax collected by merchants at the point of sale.¹⁸

Unfortunately, this basic analysis and approach ignores several important reasons to promote individual compliance with state use taxes. As an initial matter, even if Congress grants states the authority to require online vendors to collect that tax, states will likely be able to compel the collection of only a portion of the taxes due on online sales. One study suggests that more than half of the tax currently owed would go uncollected under legislation being debated in Congress due to a de minimis exemption in that bill.¹⁹ Research also suggests that consumers would

LEGISLATURES (Nov. 14, 2014), *available at* <http://www.ncsl.org/research/fiscal-policy/collecting-e-commerce-taxes-an-interactive-map.aspx#2>, *archived at* <http://perma.cc/6M8V-CAG9>.

¹⁵ *See infra* Section III.B.

¹⁶ Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. OF ECON. PERSPECTIVES 25, 37 (2007).

¹⁷ Concomitantly, it may make little sense for consumers to expend the effort to comply with the tax.

¹⁸ *See infra* Section III.B (discussing states’ efforts to get retailers to collect use taxes).

¹⁹ DONALD BRUCE & WILLIAM F. FOX, AN ANALYSIS OF INTERNET SALES TAXATION AND THE SMALL SELLER EXEMPTION, SMALL BUS. ADMIN. 40 (2013), *available at* <http://www.sba.gov/sites/default/files/rs416tot.pdf>, *archived at* <http://perma.cc/G7SA-64CW> (“Thus, the Marketplace Fairness Act with its \$1 million SSE would likely eliminate less than one-half of the losses associated with inability to collect tax on remote sales.”).

simply avoid vendors that were newly compelled to collect the tax.²⁰ The use-tax gap would thus remain significant even under the most positive of assumptions.²¹

States need not accept this fate, however. The situation is not as dire as this discussion would suggest. The prevailing attitude toward the impossibility of compelling voluntary compliance rests on a banal application of deterrence theory, but modern models of tax compliance are much more sophisticated and provide significant insight into efforts that states could undertake. This Article thus evaluates the various models of compliance and offers ways in which states and researchers could apply the resulting lessons to help close the use-tax gap.

This approach is important not only for states, but for governments worldwide. As noted above, research on tax compliance is wide-ranging and of great importance, but there is significant work yet to be done. Compliance efforts with respect to state use taxes would thus also provide a significant opportunity for the U.S. federal government and governments worldwide to learn about how to induce voluntary compliance with their taxes, especially in contexts with diffuse third-party involvement and large reliance on taxpayer effort. If states can induce compliance with a tax that is “largely unenforceable” due in large part to those reasons, the lessons learned from that success should provide significant insight into how to close tax gaps at every level of government.

The Article proceeds in five additional Parts. Part II introduces the variety of tax-compliance theories, from the classic economic or deterrence model to modern theories relying on research on procedural justice and behavioral economics. Part III provides background information on the tax gap generally and state use taxes and the use-tax gap in particular. It also discusses the limited empirical research that has been done on use-tax compliance to date. Part IV introduces a number of ways that states could apply the models of tax compliance to promote compliance with their use taxes. These include the application of well-known tax-compliance measures, as well as new methods based upon recent research. Part V ties the previous sections together by explaining why state use taxes are particularly well suited to host these experimental efforts, and Part VI concludes.

II. THE MODELS OF TAX COMPLIANCE

The question of why people comply (or fail to comply) with their legal obligations has been the subject of extensive research and scholarship that spans

²⁰ See Liran Einav et al., *Sales Taxes and Internet Commerce*, 104 AM. ECON. REV. 1, 24 (2014) (discussing consumer behavior on eBay); Brian Baugh et al., *The “Amazon Tax”*: *Empirical Evidence from Amazon and Main Street Retailers* 2–3 (Nat’l Bureau of Econ. Research, Working Paper No. 20052, 2014), available at <http://www.nber.org/papers/w20052.pdf>, archived at <http://perma.cc/CC79-56UF> (discussing consumer behavior in response to the collection of sales tax by Amazon.com).

²¹ This necessarily assumes that Congress would not grant states the ability to require the collection of tax by all vendors. The commercial concerns with, and opposition to, that approach suggest that any political solution will necessarily include a small-seller exception.

many academic disciplines. No one article could provide a complete overview of the literature on this topic. The major theories of tax compliance are, however, introduced in the following sections. Part II.A first discusses the classic deterrence model, which focuses on the pecuniary interests of taxpayers. Part II.B then discusses models that focus on other, nonpecuniary factors that may influence taxpayers' decision-making processes, including models based on (1) social norms, (2) perceptions of fairness and trust in taxing authorities, and (3) behavioral biases.

A. *The Economic Model of Tax Compliance*

1. *The Basic Deterrence Model*

The classic economic model presumes that individual citizens are rational, utility-maximizing actors. The model thus posits that one will choose to defy the law if the anticipated benefits from not complying exceed the expected costs of that action.²² That model has been applied to tax-evasion analyses since at least 1972.²³ Application of the model, however, results in estimates of compliance that are much lower than currently realized.²⁴ Those low estimates are due to the relatively low penalty and audit rates that currently exist. Assume, for example, that a taxpayer is determining whether to report \$10,000 of income. Assume further that the taxpayer would pay tax at the rate of 40% on that income, that his likelihood of being audited and having the evasion detected is 5%,²⁵ and that the penalty rate if detected would

²² Lawsky, *supra* note 5, at 248–49; Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1463–68 (2003) [hereinafter Lederman, *Interplay Between Norms*]. That formulation uses the terms “costs” and “benefits,” but would more appropriately refer to utility losses and utility gains. The economic model has long incorporated the concept of utility to recognize that each dollar is not of equivalent value to a taxpayer. Lawsky, *supra* note 5, at 254 n.43. *See also* Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 911–12 (2011) [hereinafter Lawsky, *On the Edge*] (discussing various concepts of utility). For simplicity, this Article will largely refer to costs and benefits rather than utility losses and utility gains.

²³ Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323, 323 (1972). Allingham and Sandmo exported the work of Gary Becker, who introduced the deterrence model to legal scholarship in the 1960s with his work on crime and punishment, into tax literature. *See id.* (citing Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968)).

²⁴ James Alm, *Measuring, Explaining, and Controlling Tax Evasion: Lessons from Theory, Experiments, and Field Studies*, 19 INT'L TAX AND PUB. FIN. 54, 56–60 (2012); Michele Bernasconi, *Tax Evasion and Orders of Risk Aversion*, 67 J. PUB. ECON. 123, 123–24 (1998); Lawsky, *supra* note 5, at 251–52; Lederman, *supra* note 22, at 1466–67.

²⁵ In actuality, the IRS audits approximately 1% of all individual tax returns. *Internal Revenue Service Fiscal Year 2013 Enforcement and Service Results*, IRS, <http://www.irs.gov/PUP/newsroom/FY%202013%20Enforcement%20and%20Service%20>

be 20% of the tax evaded.²⁶ On these facts, the taxpayer's anticipated benefit from noncompliance would be the \$4,000 of tax that he would save ($\$10,000 \times 40\%$) multiplied by his 95% chance of evading detection—or \$3,800. His anticipated costs of noncompliance would be his potential penalty of \$800 (20% of the \$4,000 of evaded tax) multiplied by his 5% chance of being caught—or \$40. Given an anticipated benefit of \$3,800 and an anticipated cost of \$40, compliance is not economically compelled on those facts.²⁷ This analysis thus suggests that very low levels of compliance would be common. In reality, though, voluntary compliance with federal income taxes is high, at approximately 83%.²⁸

For years, scholars have explored the factors that explain this discrepancy and have suggested many that play a role. Those tax-compliance theories are discussed below, but it must first be noted that the classic economic model is actually much more predictive than a basic application of that model—like that shown above—would suggest. This is largely because such an application utilizes a uniform, low audit rate based on the IRS' current audit practices. That approach is inappropriate, though, when looking at individual compliance decisions because audit risk is not completely exogenous. The IRS does not determine who to audit at random, but takes a more targeted approach. For example, the IRS assigns a score to returns using its Discriminant Index Function ("DIF").²⁹ The DIF is "a mathematical technique used to score income tax returns for examination potential."³⁰ The DIF formulas are confidential,³¹ but taxpayers can fairly expect that certain actions will increase their risk of audit.

As an initial matter, a taxpayer's risk of audit will differ based upon the type of income being reported or hidden. There is a meaningful difference, for example, in the audit risk associated with failing to report wage income and failing to report a small cash payment from a friend. Employers in the United States are required to withhold and remit tax on the wages that they pay to employees.³² Those withheld

Results%20--%20WEB.pdf, archived at <http://perma.cc/7N9K-S422> (last visited June 5, 2015).

²⁶ Tax underreporting can also result in imprisonment. See 26 U.S.C. § 7201 (2012). The loss of freedom for a tax offense would also be a cost that could be incorporated into the basic economic model. Given the rarity of that consequence, however, it will not be taken into account in the basic model for purposes of this Article.

²⁷ In reality, audit rates are much lower than 5% and these numbers become even more skewed against the utility of compliance. See Lederman, *supra* note 22, at 1463–66 (providing a similar simplified example and noting even further complications).

²⁸ *Tax Gap for Tax Year 2006*, IRS (Jan. 6, 2012), http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf, archived at <http://perma.cc/3NBL-UN5P> [hereinafter *Tax Gap 2006*].

²⁹ INTERNAL REVENUE SERVICE, INTERNAL REVENUE MANUAL § 4.1.3.2, available at <http://www.irs.gov/irm>, archived at <http://perma.cc/J8VF-2UYR>.

³⁰ *Id.*

³¹ *Id.* at 4.1.2.3(3).

³² 26 U.S.C. § 3402(a)(1) (2012).

and remitted amounts are reported to the employee and to the IRS annually on an IRS Form W-2.³³ That information-reporting system all but ensures that employees report all of their wage income to the IRS.³⁴ The audit rate for one not reporting the same amount of wages as reported on their W-2 is either actually 100% or perceived to be 100% in an era where computers match information returns to tax returns.³⁵

In contrast to this system, with respect to wage income, a cash payment to a self-employed individual may involve no information reporting, and there will rarely be withholding of tax at the source.³⁶ The failure to report that income thus brings

³³ 26 U.S.C. §§ 6041(a), 6051(a) (2012); Internal Revenue Service, *Form W-2*, available at <http://www.irs.gov/pub/irs-pdf/fw2.pdf>, archived at <http://perma.cc/J878-UYGJ>.

³⁴ Scholars widely recognize the impact of third-party information reporting on tax compliance. Henrik Jacobsen Kleven et al., *Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark*, 79 *ECONOMETRICA*, 651, 656 (2011); Lederman, *Tax Compliance*, *supra* note 3, at 974; Lederman, *Information Gaps*, *supra* note 2; Susan Morse, *Tax Compliance and Norm Formation Under High-Penalty Regimes*, 44 *CONN. L. REV.* 675, 679 (2012); Joel Slemrod et al., *Does Credit Card Information Reporting Improve Small-Business Tax Compliance* (Feb. 5, 2015) (manuscript at 1), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2515630, archived at <http://perma.cc/UJG8-S2HK>; Joel Slemrod, *supra* note 16, at 44 (“Overall, when relatively disinterested third parties can be required to provide information, as with wages and salaries, high compliance rates can be achieved at fairly low cost.”); Jay A. Soled, *Homage to Information Returns*, 27 *VA. TAX. REV.* 371, 371–72 (2007). Notably, at least one study has shown that information reporting has more of an impact on tax compliance than withholding at the source. See Kleven et al., *supra*, at 673–75. Those results are consistent with the results of a study on tax compliance in Chile, which suggest that the mere existence of a paper trail increases compliance, even where the government is not automatically provided a copy of that information. Pomeranz, *infra* note 52, at 5; see text accompanying notes 52–57 (discussing that study in further detail).

³⁵ Of course, the taxpayer may not undergo an actual audit, but she will receive an automated notice from the IRS correcting her income to that reported on the W-2. See *Topic 652 - Notice of Underreported Income – CP-2000*, IRS, available at <http://www.irs.gov/tax-topics/tc652.html> (last visited June 28, 2015), archived at <http://perma.cc/M26S-SULM>.

³⁶ Information reporting is generally required with respect to wage income and payments of \$600 or more made in the course of a trade or business. 26 U.S.C. §§ 6041, 6051 (2012). Under these rules, payments of less than \$600 and payments made in a personal capacity are generally not reportable unless a special provision applies. 26 U.S.C. § 6041. Payments made to corporations are also currently exempted from reporting. See *Treas. Reg.* §§ 1.6041-3(p)(1), 1.6049-4(c)(1)(ii)(A) (2009) (classifying corporations as recipients exempt from reporting under Internal Revenue Code Section 6041). Withholding is generally not required on payments made to nonemployees unless backup withholding is required or the payment is made to a foreign recipient. See 26 U.S.C. § 3406 (requiring withholding on “reportable payments” in specified situations, included when the recipient fails to furnish her taxpayer identification number as required by law); 26 U.S.C. §§ 1441, 1442 (requiring withholding on certain payments made to nonresident alien individuals and foreign corporations).

with it less audit risk than that experienced by our wage earner. Applying the traditional model, we would thus expect compliance to be much lower for people with income that is not independently reported to the IRS.

Current rates of compliance are consistent with this analysis. The IRS estimates that compliance with taxes for which there is “substantial information reporting and withholding” is roughly 99%.³⁷ On the other hand, where there is little or no information or withholding, the IRS estimates that only 44% of that income is voluntarily disclosed.³⁸ The drastic difference in compliance rates suggests that the classic economic model is more predictive than suggested when looking at aggregate numbers. The high level of wage reporting simply skews the numbers in such a way that an aggregate approach does not provide significant information about compliance.³⁹

An aggregate approach to evaluating the economic model also fails to take into account other audit-risk factors, like the extent of a taxpayer’s noncompliance.⁴⁰ It is fair to assume, for example, that a healthy business failing to report a single, low-value cash payment would not expect the same audit risk as if it failed to report 90% of its income. Similarly, a taxpayer who reports a significant change in taxable income may also expect more scrutiny. These factors thus suggest that applications of the deterrence model should incorporate conditional audit probabilities that are based on taxpayer-centric concepts.⁴¹ Recognizing disparate audit probabilities may very well help to further close the gap between predicted and observed compliance under the traditional model.⁴²

The efficacy of the economic model has been shown in at least one field experiment specifically involving a state taxing authority in the United States. That study was conducted in Minnesota and tested the economic model by attempting to impact taxpayers’ perceptions of audit risk.⁴³ Subjects in the study received a letter from the Minnesota Department of Revenue that informed them of four principal

³⁷ Theodore Black et al., *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation* 3 (2012), <http://www.irs.gov/pub/irs-soi/06rastg12workppr.pdf>, archived at <http://perma.cc/TU42-DQJY>; see also Kleven et al., *supra* note 34, at 653 (reporting that the “tax evasion rate for third-party reported income [in Denmark] is close to zero.”).

³⁸ Black et al., *supra* note 37, at 3.

³⁹ Lederman, *Tax Compliance*, *supra* note 3, at 974–76; James Andreoni et al., *Tax Compliance*, 36 J. OF ECON. LITERATURE 818, 821–22 (1998).

⁴⁰ Andreoni et al., *supra* note 39, at 821–22; Steven Klepper & Daniel Nagin, *The Anatomy of Tax Evasion*, 5 J.L. ECON. & ORG. 1, 18–20, 22–23 (1989); Shiomio Yitzhaki, *On the Excess Burden of Tax Evasion*, 15 PUB. FIN. Q. 123, 127 (1987).

⁴¹ See Terrence Chorvat, *Trust and Taxation*, in EDWARD J. MCCAFFERY & JOEL SLEMROD, BEHAVIORAL PUBLIC FINANCE 210–11 (2006).

⁴² It is unlikely, however, that it completely closes that gap. Chorvat, *supra* note 41, at 210–11. It is also possible that endogenous audit probabilities based upon the levels of tax evaded might cause *more* noncompliance. *Id.* at 211.

⁴³ Joel Slemrod et al., *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. PUB. ECON. 455, 455–56 (2001).

items: (1) that they had been selected to be a part of a study that would increase the number of taxpayers that would be audited;⁴⁴ (2) that their state and federal returns would be “closely examined” by the state;⁴⁵ (3) that they would be contacted about any discrepancies;⁴⁶ and (4) that their returns might be reviewed if any “irregularities” were found.⁴⁷ The researchers found some meaningful results.

First, with respect to low- and middle-income groups, the government communications had a “very large impact” on the reporting of taxpayers with a high opportunity to evade—the middle-income group reported an increase in tax of 12.1% and the low-income group reported an increase in tax of 145.3%, though the latter result was not statistically significant at the 10% level.⁴⁸ The researchers also found a positive impact on the compliance of low- and middle-income taxpayers who had a low opportunity to evade, but that impact was not statistically significant.⁴⁹ The researchers noted one other interesting result. Among the high-income taxpayers, the experiment actually resulted in *lower* levels of compliance.⁵⁰ This was true for those taxpayers in both the low- and high-opportunity groups.⁵¹ The combination of these results suggests (1) that efforts to increase taxpayer perception of audit risk can be beneficial and (2) that caution must be taken with respect to high-income taxpayers.

A similar experiment was recently conducted with respect to the Chilean value added tax (VAT).⁵² In that experiment, the Chilean taxing authority also sent letters

⁴⁴ *Id.* at 462–63.

⁴⁵ *Id.* at 463.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Slemrod et al., *supra* note 43, at 465. A taxpayer was classified as having a high opportunity to evade taxes if the taxpayer filed a Schedule C or E (for business and farm income, respectively) and paid Minnesota estimated taxes. *Id.* at 461. All other taxpayers were classified as having a low opportunity to evade. *Id.* at 462.

⁴⁹ *Id.* at 465.

⁵⁰ *Id.* at 476.

⁵¹ *Id.* at 476–77. The researchers posited two possible explanations for this result. First, the communication from the state may have caused high-income taxpayers to seek guidance from professional tax advisors, who may have determined legitimate tax-reduction methods. *Id.* at 477. The possibility of this explanation was uncertain because, although there was no significant change in those taxpayers who actually used tax-return preparers, the identity of, aggressiveness of, or directions given to those preparers was unknown. Second, it is possible that those taxpayers expected an audit and would have rather entered the audit with a lower “opening bid.” *Id.*

⁵² Dina Pomeranz, *No Taxation Without Information: Deterrence and Self-Enforcement in the Value Added Tax 5* (Nat’l Bureau of Econ. Research, Working Paper No. 19199, 2013), http://www.hbs.edu/faculty/Publication%20Files/pomeranz_no_taxation_without_information_c2f18227-578f-4259-b75b-f62f2e113217.pdf, archived at <http://perma.cc/5TCU-25ME>. A value added tax, or VAT, is a form of consumption tax that is collected throughout the stages of production rather than at the end point of sale. See generally Seth E. Terkper, WG&L VAT HANDBOOK ¶ 1.01–1.02 (2011).

aimed at increasing the recipients' perceptions of audit probability.⁵³ However, the study was unique in that it was not seeking to understand the impact of the letters alone. Rather, the researchers were seeking to understand how such letters interacted with the presence of a paper trail regarding the taxed transactions.⁵⁴

The data from that study showed that there was a positive impact on compliance from the deterrence letter—at least in the short term.⁵⁵ They also showed that the deterrence letters had an insignificant impact on reported figures for which a paper trail was available, but that compliance did increase significantly with respect to amounts for which a paper trail did not exist.⁵⁶ The author of the study thus concluded that paper trails have a “preventive deterrence effect” that leads to greater voluntary compliance absent government intervention.⁵⁷ The study provides further support for the efficacy of the deterrence model.

It is also worth noting two alternative consequences that may result from increased audit activity or the threat thereof. First, there may be an “indirect audit effect” that causes increased compliance by those who simply become aware of others being audited.⁵⁸ This would suggest that audits have a greater economic effect than the funds directly collected from those audits. On the other hand, however, increased enforcement may have a “crowding out” effect that could actually result in *lower* levels of compliance.⁵⁹ Increased enforcement actions may serve as a signal to taxpayers that others are not complying and, therefore, that there may not be a social norm of compliance.⁶⁰ This could cause individuals to reduce their own compliance. This theory is not without critique, but tax administrators should be cognizant of this possibility.⁶¹

The import of this discussion is to suggest that the economic model can explain the high rates of voluntary compliance in the United States much more than seemingly presumed by some current scholarship. When taking into account individualized audit risk, the traditional model can be much more predictive than assumed when using aggregate audit rates. This does not mean that the other models of tax compliance are irrelevant. It only means that researchers should not discount

⁵³ Pomeranz, *supra* note 52, at 9.

⁵⁴ For purposes of the study and this discussion, the term “paper trail” refers to the bilateral filing obligations imposed on companies reporting intermediate transactions under a VAT. In those situations, a seller is obligated to report its sale and the buyer will report its purchase in order to get credit for its input cost. There is thus a paper trail, of sorts, for each party. *Id.* at 9–10.

⁵⁵ *Id.* at 18.

⁵⁶ *Id.* at 19.

⁵⁷ *Id.* at 21.

⁵⁸ Alm, *supra* note 24, at 3–4; Lederman, *supra* note 22, at 1494–95 (2003); Morse, *supra* note 34, at 711 n.145.

⁵⁹ Lederman, *supra* note 22, at 1461–62, 1495–96.

⁶⁰ *Id.* at 1495–96.

⁶¹ *See id.* at 1497–99.

the value of the economic model and the powerful impact of withholding and information reporting.⁶²

B. Nonpecuniary Models of Tax Compliance

The disconnect between the levels of compliance that the traditional model predicts and those that are actually experienced has caused scholars to seek alternative rationales for explaining taxpayer compliance. The literature in the area is vast and complex, and the following materials provide a basic introduction to several alternative models.⁶³ Very loosely, these all rely on psychological or sociological factors that look beyond a pure deterrence approach. The models seek to introduce noneconomic factors that play into taxpayers' decision-making processes, including factors like (1) social norms, (2) citizens' views toward the legitimacy or fairness of government, and (3) a variety of behavioral influences that cause seemingly "irrational" choices under the classic model.⁶⁴ Each of these factors is discussed below.

1. Social Norms and Compliance

One significant nonpecuniary model of tax compliance suggests a social-norm rationale for tax-compliance decisions.⁶⁵ That model is "complex,"⁶⁶ but suggests that a taxpayer will comply with tax laws as long as she believes that compliance is the norm, at least within a group with whom she identifies.⁶⁷ Conversely, she will

⁶² While the economic model may explain compliance under the conditions discussed herein, research suggests that compliance is still higher than would be predicted under the classic model for types of income that are not subject to information reporting or withholding at the source. See Erzo F. P. Luttmer & Monica Singhal, *Tax Morale*, 28 J. ECON. PERSP. 149, 152–53 (2014).

⁶³ The literature in this area is voluminous, and even rudimentary discussions take the form of a book. See, e.g., KEN DEVOS, *FACTORS INFLUENCING TAXPAYER COMPLIANCE BEHAVIOR* 228–30 (Springer 2014); ERICH KIRCHLER, *THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR* 64–70 (Cambridge University Press 2007); MICHAEL PICKHARDT & ALOYS PRINZE, *TAX EVASION AND THE SHADOW ECONOMY* 6–8 (2012); *WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT* 2 (Joel Slemrod ed., University of Michigan Press 1992).

⁶⁴ Broadly, these nonpecuniary factors can be swept into the concept of "tax morale." See Luttmer & Singhal, *supra* note 62, at 151.

⁶⁵ See, e.g., James Alm et al., *Changing the Social Norm of Tax Compliance by Voting*, 52 KYKLOS 141, 142 (1999); Steven E. Kaplan & Philip M. J. Reckers, *A Study of Tax Evasion Judgments*, 38 NAT'L TAX J. 97, 97–98 (1985); Erich Kirchler et al., *Enforced Versus Voluntary Tax Compliance: The "Slippery Slope" Framework*, 29 J. ECON. PSYCH. 210, 217–18 (2008); KIRCHLER, *supra* note 63, at 64–70; Lederman, *supra* note 22, at 1459 n.29.

⁶⁶ Kirchler et al., *supra* note 65, at 218.

⁶⁷ See, e.g., DEVOS, *supra* note 63, at 230 ("The impact of social norms is relevant, as the majority who believe that others are compliant are compliant themselves."); KIRCHLER,

not comply if she feels that most people in her reference group do not do so.⁶⁸ This social-norm framework can be viewed as consistent with the basic economic model if we assume a utility loss when a taxpayer acts as a deviant by failing to fully report his or her income.⁶⁹ Feelings of guilt or shame act as a cost of noncompliance under that construct. This is consistent with survey responses in which many taxpayers report that they would feel embarrassed if others were informed that they did not report all of their income.⁷⁰ This may suggest that taxpayers simply do not want to be identified as a tax cheat, rather than being afraid of the resulting monetary penalty.

The social-norm model of tax compliance suggests that taxing authorities must be especially aware of how they communicate with taxpayers. Communications that focus on tax evasion or the extent of the tax gap can actually have a negative impact on tax compliance by signaling a low norm of compliance.⁷¹ In contrast, communications that highlight compliant behavior by others could have a positive impact on compliance.⁷² Recent field experiments provide conflicting results on the impact of such social-norm messages. For example, government communications that incorporated social-norm messages did result in increased compliance in two recent experiments conducted in the United Kingdom.⁷³ Notably, those studies

supra note 63, at 64–70; Michael Wenzel, *The Social Side of Sanctions: Personal and Social Norms as Moderators of Deterrence*, 28 LAW & HUM. BEHAV. 547, 547 (2004) (studying the impact of personal and social norms on the effects of deterrence on tax evasion). Under this formulation, social norms refer to a view about whether others are complying. *Id.* at 550. Related research looks toward a person's internal motivation to comply with the tax laws or their personal beliefs regarding compliance, which may be impacted by their beliefs regarding a social norm of tax compliance. *See* DEVOS, *supra* note 63, at 6, 28–30; Kornhauser, *supra* note 3, at 612–17 (discussing the internalization of social norms as internal norms).

⁶⁸ KIRCHLER, *supra* note 63, at 64–70; Alm et al., *supra* note 65, at 142; Kornhauser, *supra* note 3, at 612–17; Michael Wenzel, *Misperceptions of Social Norms About Tax Compliance: From Theory to Intervention*, 26 J. OF ECON. PSYCHOL. 862, 863–64, 881 (2005); *cf.* Tom Beers et al., *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, 2012 TAXPAYER ADVOC. SERVICE, 1, 21, <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/downloads/Research-Studies-Factors-Influencing-Voluntary-Compliance-by-Small-Businesses-Preliminary-Survey-Results.pdf>, archived at <http://perma.cc/R39Q-U8DH> (reporting data showing that highly compliant taxpayers were less likely than their low compliance peers to report that their competitors were complying with their tax obligations).

⁶⁹ Alm et al., *supra* note 65, at 149–50; Slemrod, *Cheating Ourselves*, *supra* note 16, at 40 n.3.

⁷⁰ Beers et al., *supra* note 68, at 22.

⁷¹ Lederman, *The Interplay Between Norms*, *supra* note 22, at 1486–87.

⁷² KIRCHLER, *supra* note 63, at 70.

⁷³ Michael Hallsworth et al., *The Behaviorist as Tax Collector: Using Natural Field Experiments to Enhance Tax Compliance* 17–19, (Nat'l Bureau of Econ. Research, Working

focused on the payments of taxes that the taxpayers had already declared as due.⁷⁴ A prior study conducted in Minnesota tested the impact of social-norm messages in the context of taxpayers' initial tax filings, but did not find any statistically significant evidence of a benefit from those messages.⁷⁵ That study thus provides an interesting counterpoint to the U.K. study,⁷⁶ and further research is warranted. In the end, though, regardless of whether normative appeals can increase compliance, it appears as though the existence of a compliance norm, in and of itself, does impact compliance.⁷⁷

2. *Fairness, Trust, and Tax Compliance*

Taxpayers' compliance decisions may also depend on their perceptions of the fairness of the tax system.⁷⁸ In the compliance literature, the concept of "fairness" is often broken down into three distinct categories—distributive justice, procedural justice, and retributive justice.⁷⁹ In the tax context, distributive justice refers to the fairness of the allocation of the tax burden across the population. We can view distributive fairness from the perspective of horizontal equity (i.e., whether the tax burden is distributed fairly among like individuals), vertical equity (i.e., whether the tax burden is distributed appropriately among people with different levels of

Paper No. 20007, 2014), available at <http://www.nber.org/papers/w20007>, archived at <http://perma.cc/YU5V-35HC>.

⁷⁴ *Id.* at 4–5.

⁷⁵ Marsha Blumenthal, Charles Christian & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125, 126 (2001).

⁷⁶ An analysis of the study by a member of the Minnesota Department of Revenue was more positive regarding the outcome of the study. That analysis concluded that the use of descriptive norm statements provided the "most cost-effective potential for increasing voluntary compliance." Stephen Coleman, *Income Tax Compliance: A Unique Experiment in Minnesota*, 13(2) GOV'T FIN. REV. 11, 14 (1997).

⁷⁷ KIRCHLER, *supra* note 63, at 66; see DIANA ONU & LYNNE OATS, SOCIAL NORMS AND TAX COMPLIANCE 5, Paper No. 006-14, 2014, http://tarc.exeter.ac.uk/media/universityofexeter/businessschool/documents/centres/tarc/publications/discussionpapers/Social_norms_and_tax_compliance_May_14.pdf, archived at <http://perma.cc/2LPG-BTH9>.

⁷⁸ Some research suggests that fairness determinations may be among the most important in predicting taxpayer compliance. Eva Hofmann et al., *Preconditions of Voluntary Tax Compliance: Knowledge and Evaluation of Taxation, Norms, Fairness, and Motivation to Cooperate*, 216 J. OF PSYCHOL. 209, 212 (2008). It seems safe to suggest that this position holds true only outside of areas where compliance is essentially compelled through withholding and information reporting. The fairness model should be viewed as predicting behavior among the groups with realistic opportunities to evade.

⁷⁹ See DEVOS, *supra* note 63, at 6–7; Hofmann et al., *supra* note 78, at 212; Michael Wenzel, *Tax Compliance and the Psychology of Justice: Mapping the Field*, in TAXING DEMOCRACY 41, 45–46 (Valerie Braithwaite ed., 2002).

income), and exchange equity (i.e., whether the tax burden is distributed appropriately based upon the benefits that individuals receive from government).⁸⁰

The concept of distributive justice must be taken into account in any comprehensive review of the motivators of tax compliance. This Article, however, will not focus on how to test compliance theories by modifying the actual distribution of tax burdens or the provision of government services. Those matters involve fundamental questions of governance, and modifying current practices to achieve greater use-tax compliance is too much to ask from an experimental standpoint. It is fair to think, though, about how taxing authorities could change taxpayers' perceptions regarding these matters. For example, behavioral research suggests that taxpayer preferences on the distribution of the tax burden could vary based simply on how the information is presented.⁸¹ Additionally, governments could change taxpayers' perceptions of exchange equity simply by making government services more salient to taxpayers without actually changing how, or to whom, those services are provided.

Our other two forms of fairness—procedural and retributive justice—can be discussed in the context of research showing that compliance with the laws is impacted by individuals' views on the legitimacy of government's authority.⁸² That research suggests that people who view an authority as legitimate are generally more likely to comply with the commands of that authority regardless of their personal feelings regarding the desirability of the commanded act.⁸³ It also suggests that the legitimacy of government is determined, in part, by citizens' perceptions of the trustworthiness of government and by their perceptions of the fairness of the

⁸⁰ Hofmann et al., *supra* note 78, at 212.

⁸¹ See Edward J. McCaffery & Jonathan Baron, *Thinking About Tax*, 12 PSYCHOL., PUB. POL'Y & L. 106, 113–15 (2006) (showing that individuals' perceptions of tax matters are impacted by factors such as whether the information is presented in absolute or percentage terms and whether tax provisions are structured as bonuses or penalties).

⁸² TOM R. TYLER, WHY PEOPLE OBEY THE LAW 25–27 (2006) [hereinafter TYLER, WHY PEOPLE OBEY]; Levi et al., *Conceptualizing Legitimacy, Measuring Legitimizing Beliefs*, 53 AM. BEHAV. SCIENTIST 354, 354–56 (2009) [hereinafter Levi et al., *Conceptualizing Legitimacy*]. See generally Margaret Levi et al., *The Reasons for Compliance with Law, in UNDERSTANDING SOCIAL ACTION, PROMOTING HUMAN RIGHTS* 70–99 (Oxford University Press 2012) [hereinafter Levi et al., *Reasons for Compliance*] (describing research results that support the claim that individuals' views regarding the legitimacy of government authority impact voluntary compliance rates). The concept of “procedural justice” is broad, but can be defined as, “the fairness of different ways of resolving conflicts or making allocations.” TYLER ET AL., SOCIAL JUSTICE IN A DIVERSE SOCIETY 11–12 (1997). The concept of “retributive justice” refers to considerations of “how people react to the breaking of social rules” and the “attribution of responsibility for and responses to the breaking of social rules.” *Id.* at 12.

⁸³ TYLER, WHY PEOPLE OBEY, *supra* note 82, at 57–62; Levi et al., *Conceptualizing Legitimacy*, *supra* note 82, at 354.

processes used by government.⁸⁴ Though these two concepts are related, they are distinct.⁸⁵ Citizens' perceptions regarding the trustworthiness of government depend, in part, on their judgments regarding the motivations, competence, and performance of government officials.⁸⁶ Citizens' perceptions regarding procedural justice, on the other hand, more specifically depend on the fairness of the processes that the government uses in its interactions with citizens.⁸⁷

Research suggests that trust in government indeed has a positive impact on voluntary compliance⁸⁸ and that the way in which the government exercises its power can impact citizens' trust determinations.⁸⁹ It also suggests that administrative competence may be a significant factor in citizens' perceptions of the trustworthiness of government and that competency judgments include evaluations of whether the government will enforce the laws against those who do not comply.⁹⁰ That is because "coercion is important for reassuring citizens that others will be punished. It signals government competence and protects citizens from being a sucker while others free ride."⁹¹ In one study, citizen perception that the government was competent and honest translated into a fifteen-percentage-point increase in the probability that a taxpayer would accept the tax administrator's authority.⁹²

⁸⁴ Levi et al., *Conceptualizing Legitimacy*, *supra* note 82, at 356. This research differentiates between "value-based legitimacy" and "behavioral legitimacy." The former refers to individuals' internal sense that they *should* obey a government mandate. The latter refers to whether they actually do so. *Id.* at 356. The research of Levi, Tyler, and Sacks suggests that value-based legitimacy enhances behavioral legitimacy. Levi et al., *Reasons for Compliance*, *supra* note 82, at 82–84. That is, when people feel an obligation to comply with the law, they generally do so.

⁸⁵ *Id.* at 72.

⁸⁶ *Id.*

⁸⁷ TYLER, WHY PEOPLE OBEY, *supra* note 82, at 175.

⁸⁸ KIRCHLER, *supra* note 63, at 202–06; Beers et al., *supra* note 68, at 4; Katharina Gangl et al., "How can I help you?" *Perceived Services Orientation of Tax Authorities and Tax Compliance*, 69 PUB. FIN. ANALYSIS 487, 501–04 (2013).

⁸⁹ Lars P. Feld & Bruno S. Frey, *Deterrence and Tax Morale: How Tax Administrations and Taxpayers Interact*, 3 OECD PAPERS 1, 15 (2003); Gangl et al., *supra* note 88, at 500–04; Kirchler et al., *supra* note 65, at 213.

⁹⁰ Levi et al., *Reasons for Compliance*, *supra* note 82, at 73; Margaret Levi & Audrey Sacks, *Legitimizing Beliefs: Sources and Indicators* 12, 15–16 (Afrobarometer, Working Paper No. 74, 2007), available at <http://afrobarometer.org/sites/default/files/publications/Working%20paper/AfropaperNo74.pdf>, archived at <http://perma.cc/QA2H-AQZY>. In this way, enforcement impacts both taxpayers' views of retributive and procedural justice. This is very important in our discussion of use-tax compliance since enforcement of those taxes is virtually nonexistent.

⁹¹ Levi et al., *Reasons for Compliance*, *supra* note 82, at 73.

⁹² *Id.* at 79–80, 80 n.7 (reporting results from survey data from a number of Sub-Saharan African countries). That result is consistent with the results of research on the role and importance of retributive justice in society. See TOM R. TYLER ET AL., SOCIAL JUSTICE IN A DIVERSE SOCIETY 103–32 (1997) (discussing research on retributive justice). Although the

Significant research also establishes that citizens' beliefs regarding the legitimacy of government are tied to concepts of procedural justice.⁹³ The procedural-justice literature establishes that citizens care about decision-making processes and think about "representation, neutrality, bias, honesty, quality of decision, and consistency."⁹⁴ They "value being treated politely and having respect shown for their rights."⁹⁵ As a result, individuals may be motivated to comply based more on the fairness of their prior interactions with an authority than on the actual outcomes of those interactions.

This work has been extended specifically to tax compliance with generally positive results. In one study, a citizen's belief that the government operated in a procedurally just manner corresponded to an increase of 14.33 percentage points in the probability that the taxpayer would defer to the authority of the tax administrator.⁹⁶ A study performed in Australia also showed positive impacts on compliance when fairness concepts were incorporated into reminder letters that were sent to taxpayers.⁹⁷ Other studies on the interplay between procedural justice and tax compliance show similar results.⁹⁸

In the tax context, a procedural-justice framework would suggest that a taxpayer undergoing an audit will base her opinion of the revenue authority on how well she is treated in the audit rather than on the results of that audit.⁹⁹ Therefore, the tone and method of the taxing authority's communications¹⁰⁰ and its respect for taxpayers should also matter.¹⁰¹ The procedural-justice framework would also suggest that taxpayers should not be penalized harshly for violations that were not purposeful, involved de minimis amounts, involved unclear law, or were previously

reasons for why individuals care about retributive justice are uncertain, individuals do generally care that those who do not comply with social norms are sanctioned. *Id.*; see KIRCHLER, *supra* note 63, at 87–90. Those sanctions can be monetary or social, but justice requires some signal that the noncompliant behavior was deviant.

⁹³ Levi, *Conceptualizing Legitimacy*, *supra* note 82, at 359–60; TYLER, *supra* note 82, at 170–73.

⁹⁴ TYLER, *WHY PEOPLE OBEY*, *supra* note 82, at 175.

⁹⁵ *Id.*

⁹⁶ Levi et al., *Reasons for Compliance*, *supra* note 82, at 80.

⁹⁷ Michael Wenzel, *A Letter from the Tax Office: Compliance Effects of Informational and Interpersonal Justice*, 19 SOC. JUST. RES. 345, 358 (2006).

⁹⁸ See, e.g., Beers et al., *supra* note 68, at 15 (reporting that principles of procedural justice appear to impact taxpayer behavior); Hartner et al., *Procedural Fairness and Tax Compliance*, 38 ECON. ANALYSIS & POL'Y 137, 149–50 (2008) (reporting a "clear direct effect of procedural justice on motivational postures" in all sampled groups); Kristina Murphy, *Procedural Justice, Shame and Tax Compliance* 23 (Ctr. for Tax Sys. Integrity, Working Paper No. 50, 2003) (evaluating the negative impacts of enforcement actions on tax compliance).

⁹⁹ KIRCHLER, *supra* note 63, at 84–85.

¹⁰⁰ See Feld & Frey, *supra* note 89, at 2–3; Hallsworth et al., *supra* note 73, at 4–5; Wenzel, *supra* note 97, at 346–47.

¹⁰¹ Murphy, *supra* note 98, at 20–23; KIRCHLER, *supra* note 63, at 84–85.

unenforced. The essence of procedural justice is “a commitment of government to uphold the laws fairly and to apply them equally to all.”¹⁰² Any violation of those fundamental concepts of fairness threatens to undermine citizens’ views of the legitimacy of the government’s authority.¹⁰³

One additional line of procedural-justice research may be helpful when discussing how to close the use-tax gap. That research suggests that allowing individuals a voice in the decision-making process helps to increase their perceptions of procedural justice.¹⁰⁴ Importantly, the role of voice in that process can be instrumental, noninstrumental, or both.¹⁰⁵ That is, people may value having a voice because it makes them feel as though they can influence the outcome, or they may value having a voice because having a voice is valuable in and of itself.¹⁰⁶ The noninstrumental role has been shown through experimentation to produce a result

¹⁰² Levi et al., *Reasons for Compliance*, *supra* note 82, at 74.

¹⁰³ Research from Australia also suggests that how one deals with shame can play a role in compliance decisions and that how a person deals with shame can be impacted by punishment that is considered to be procedurally unjust. Murphy, *supra* note 98, at 1–6; *see also* KIRCHLER, *supra* note 63, at 63–64 (2007) (discussing the role of shame in tax compliance). Using survey data from individuals who had previously been accused of tax noncompliance, researchers analyzed how procedural-justice considerations impacted how individuals dealt with their feelings of shame and how those feelings impacted future compliance. The study found that those individuals were “significantly more likely to displace their shame, and were significantly less likely to acknowledge their shame, than taxpayers from the general population.” Murphy, *supra* note 98, at 20. It also found that individuals who had perceived their earlier treatment by the tax authority as unfair were more likely to displace their shame. *Id.* at 21. (The author of the study recognizes that individuals who displace their shame may simply be more likely to perceive government procedures as unfair, but calls for further research in the area. *Id.* at 25.) This research merely serves as a call for more attention to be paid to the role of emotions in the procedural-justice scholarship. However, it does lend credence to a compliance model that considers how tax authorities treat taxpayers. This is consistent with studies that evidence a link between procedural fairness and normative commitments to compliance. *See* Lederman, *Tax Compliance*, *supra* note 3, at 1,000 (discussing two studies that “suggest” a link between procedural fairness and beliefs about compliance with tax laws).

¹⁰⁴ *See* John Angus Hildreth et al., *Revisiting the Instrumentality of Voice: Having Voice in the Process Makes People Think They Will Get What They Want*, 27 SOC. JUST. RES. 209, 210 (2014); Kornhauser, *supra* note 3, at 614; Levi et al., *Conceptualizing Legitimacy*, *supra* note 82, at 360.

¹⁰⁵ Hildreth et al., *supra* note 104, at 211–12; Tom R. Tyler & Steven L. Blader, *The Group Engagement Model: Procedural Justice, Social Identity, and Cooperative Behavior*, 7 PERSONALITY & SOC. PSYCHOL. REV. 349, 351 (2003) (discussing studies showing instrumental and noninstrumental values).

¹⁰⁶ Hildreth et al., *supra* note 104, at 211–12. The latter effect can be attributed to a group-value model, under which people feel as though having a voice reflects their status as a valued member of the group and not a mere subject of control. Lind et al., *Voice, Control, and Procedural Justice: Instrumental and Noninstrumental Concerns in Fairness Judgments*, 59 J. OF PERSONALITY & SOC. PSYCHOL. 952, 952–53 (1990).

that may seem counterintuitive—that voice can increase feelings of procedural justice even when a person is fully informed that her opinion will not change the relevant matter.¹⁰⁷

The concept of voice has been applied to the tax context specifically through research on the impact of allowing taxpayers to vote on the allocation of their tax payments. Research has found that tax compliance is indeed higher when the use of the funds is voted on and the outcome is widely supported.¹⁰⁸ For example, in one recent study, participants were asked to make nonbinding allocations of their tax dollars and then to take a tax-return position on an item of questionable legality.¹⁰⁹ Those who were previously asked to suggest an allocation of a portion of their tax dollars showed a lessened likelihood of taking the questionable position.¹¹⁰ That impact revealed itself when taxpayers were able to allocate as little as 10% of their payment and dissipated after a 25% allocation.¹¹¹ That study follows others that show that taxpayers are more highly compliant when they are asked for their preferences on how their tax monies will be spent or are otherwise more fully involved in determining budgetary policy.¹¹²

¹⁰⁷ Lind et al., *supra* note 106, at 955–56.

¹⁰⁸ See James Alm et al., *Fiscal Exchange, Collective Decision Institutions, and Tax Compliance*, 22 J. OF ECON. BEHAV. & ORG. 285, 288 (1993); Lars P. Feld & Jean-Robert Tyran, *Tax Evasion and Voting: An Experimental Analysis*, 55 KYKLOS 197, 199 (2002); Cait Lambertson et al., *Eliciting Taxpayer Preferences Increases Tax Compliance* (Harv. Bus. Sch., Working Paper No. 14-106, 2014), available at <http://ssrn.com/abstract=2365751>, archived at <http://perma.cc/JPG2-E8ZP>; Wahl et al., *The Impact of Voting on Tax Payments*, 63 KYKLOS 144 (2010).

¹⁰⁹ Lambertson et al., *supra* note 108, at 11–13.

¹¹⁰ *Id.* at 19–20.

¹¹¹ *Id.* at 21 (noting that “effects on compliance were seen when agency was provided over as little as 10% of tax dollars and decay after 25% agency is provided”).

¹¹² See Alm et al., *supra* note 108, at 288; Feld & Tyran, *supra* note 108, at 199; see also KIRCHLER, *supra* note 63, at 38–39. The positive impact on compliance seen from these voting procedures may be mediated by citizens’ trust in government. That is, voting may not lead to great feelings of procedural justice directly, but may lead to greater trust in government, which may then lead to greater perceptions of procedural justice. Wahl et al., *supra* note 108, at 154–56 (discussing the mediating impact of trust). Allowing citizens a more direct say in government expenditures could also help to address exchange equity, a component of distributive justice. See *supra* notes 81–82 and accompanying text. Eliciting taxpayer preferences makes the connection between tax payments and the government services they fund more salient. Attention to greater citizen participation regarding the use of tax funds is thus merited.

3. Behavioral Economics and Tax Compliance

Traditional economic analyses of taxpayer behavior have relied upon the assumption that individuals are rational actors who seek to maximize personal utility. Under those assumptions, taxpayer decisions should not be affected by factors like the framing of choices, the labeling of payments, or where a document is signed. Research shows, however, that each of those factors can have an impact.¹¹³ The field of behavioral economics attempts to identify, categorize, and explain the variety of behavioral influences and their impacts on human decision making. Significant public attention has been given to this work thanks in part to the success of the work of Professors Richard Thaler and Cass Sunstein and their appropriation of the term “nudge” to describe the use of behavioral factors and choice architecture to impact individual behavior.¹¹⁴ In response to this work, the United Kingdom developed a so-called “nudge unit” to develop ways to “apply[] ideas from the behavioural sciences to public policy.”¹¹⁵ The Obama administration has also worked to create a similar unit in the United States.¹¹⁶ Insights from behavioral economics have already been applied to inform government behavior on issues ranging from organ donation to retirement savings.¹¹⁷ Fortunately, a significant amount of work has also been done to apply these behavioral concepts to the field of tax compliance specifically. A full discussion of these concepts is well beyond the scope of this Article, but a few of the more prominent behavioral influences are relevant when thinking about use-tax compliance.

¹¹³ See *infra* notes 119–129 (discussing framing and labeling effects); Lisa L. Shu et al., *Signing at the Beginning Makes Ethics Salient and Decreases Dishonest Self-Reports in Comparison to Signing at the End*, 109 PROC. OF THE NAT'L ACAD. OF SCI. 15197 (2012) (discussing the impact of the placement of a signature line on compliance).

¹¹⁴ See generally RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE* (2008).

¹¹⁵ *About Us*, THE BEHAVIORAL INSIGHTS TEAM, <http://www.behaviouralinsights.co.uk/about-us>, archived at <http://perma.cc/3WU7-PFVJ>. The U.K. unit started as a component of the U.K. government, but has since been restructured as a public-private partnership. *Id.*

¹¹⁶ The Office of Science and Technology currently lists a “Social & Behavioral Sciences Initiative,” which “promotes collaborations among Federal agencies in order to embed social and behavioral research insights into a range of policy initiatives—from health care to education—and to test outcomes using rigorous experimentation and evaluation methods.” *OSTP Initiatives*, OFFICE OF SCI. AND TECH. POLICY, <http://www.whitehouse.gov/administration/eop/ostp/initiatives>, archived at <http://perma.cc/PC37-2L8S>. See also Richard Thaler, *Public Policies, Made to Fit People*, N.Y. TIMES, Aug. 25, 2013, at BU6 (discussing the creation of this initiative).

¹¹⁷ THALER & SUNSTEIN, *supra* note 114, at 105–19, 177–84; CABINET OFFICE ET AL., *APPLYING BEHAVIOURAL INSIGHTS TO ORGAN DONATION: PRELIMINARY RESULTS FROM A RANDOMISED CONTROLLED TRIAL*, GOV.UK (Dec. 24, 2013), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/267100/Applying_Behavioural_Insights_to_Organ_Donation.pdf, archived at <http://perma.cc/XWQ3-JX2V>.

Perhaps the most significant insights from behavioral economics, as it relates to tax compliance, stem directly from Professors Daniel Kahneman and Amos Tversky's early recognition of the impacts of framing effects on individuals' decision-making processes.¹¹⁸ Kahneman and Tversky noted that individuals did not tend to evaluate decisions in the abstract, but did so from some reference point.¹¹⁹ Thus, in the tax context, a tax liability of \$5,000 may be viewed differently depending on the expectation of the taxpayer. If she expected to pay \$6,000, she would view the payment more favorably than if she had expected to pay \$4,000 or \$0. In either case, though, she would have parted with the same funds.

Another important aspect of framing is the relationship between a reference point and individuals' risk preferences. Kahneman and Tversky found that people generally tend to have greater risk tolerance when facing losses than when facing gains.¹²⁰ To illustrate, assume that a person is offered an absolute right to \$500 or the ability to get \$1,200 if a coin is flipped and lands heads up. If the coin lands tails up, she gets nothing. The expected return from engaging in the coin flip is thus \$600.¹²¹ However, because the person is facing the possibility of a gain, research shows that she will be more likely to take the \$500 rather than take a risk on the coin flip.¹²² If we reversed the situation, however, (and told the person that she would either lose \$500 for sure, or that by flipping a coin she could lose \$0 or \$1,200), research shows that she would be more willing to take the risk and flip the coin to avoid the sure loss.¹²³ Behavioral economists thus say that individuals are generally risk *seeking* with respect to losses and risk *averse* with respect to gains.¹²⁴

Scholars have applied this research on framing and risk tolerance to explain the impact of tax withholding on taxpayer behavior. Under a pure economic model, the receipt of a tax refund should generally be a negative occurrence for a taxpayer because it means that the taxpayer has essentially given the government an interest-

¹¹⁸ Amos Tversky & Daniel Kahneman, *Prospect Theory: An Analysis of Decision under Risk*, 47 *ECONOMETRICA* 263 (1979).

¹¹⁹ *Id.* at 286–88.

¹²⁰ *Id.* at 284–86; Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 *SCI.* 453, 454 (1981) [hereinafter Tversky & Kahneman, *Framing*].

¹²¹ The expected return from the coin flip is the sum of a 50% chance of receiving the \$1,200 (\$600) and a 50% chance of receiving nothing (\$0)—a sum equal to \$600.

¹²² Tversky & Kahneman, *Framing*, *supra* note 120, at 454.

¹²³ *Id.*

¹²⁴ *Id.* Interestingly, the impact of framing on risk aversion holds true even where the real change is not between losses and gains, but the situation is merely presented differently. Assume, for example, that a doctor suggests a course of treatment for a patient's significant medical condition. The patient's determination about whether to proceed with the course of treatment is influenced by whether the doctor presents the success rate or the mortality rate, though the underlying information and probabilities are the same. When presented with success rates (a gain), persons will tend to choose the less risky of two options. When presented with mortality rates (a loss), persons will tend to choose the riskier of the options. *Id.* at 453.

free loan from the time that the tax was withheld until the receipt of the refund. Taxpayers, however, often view tax refunds as windfalls and positive events. They seem to adopt the amount withheld as their frame of reference for evaluating gains and losses instead of their gross earnings. Scholars have suggested that the government could harness this framing effect by requiring “advance payments” by independent contractors and others for whom wage withholding is not available.¹²⁵ They opine that those taxpayers will be put into a gain framework if they seek a refund and thus take less risk.¹²⁶ This would, in turn, increase government revenues as tax cheating would be reduced.¹²⁷

Many other behavioral factors and biases impact human decision-making and tax-compliance decisions. People respond differently to exactions labeled as taxes rather than as fees.¹²⁸ They prefer the provision of credits to the imposition of penalties even when the impacts are the same.¹²⁹ People discount future gains and losses much too significantly, and thus show an illogical preference for current consumption—a concept often referred to as hyperbolic discounting.¹³⁰ People accept many smaller taxes over one larger tax that imposes the same burden.¹³¹ People value assets more after they own them—an effect called the endowment effect.¹³² People are more honest when they sign forms at the top of the page than at the bottom of the page.¹³³ The list goes on and on.¹³⁴

The opportunities and challenges presented by behavioral economics and behavioral psychology are immense. Scholars are working to categorize and test the biases and heuristics that have been identified, and that work will undoubtedly shape how we view tax compliance in the future.

¹²⁵ See Henk Elffers & Dick H. Hessing, *Influencing the Prospects of Tax Evasion*, 18 J. OF ECON. PSYCH. 289, 292–93 (1997); Kathleen Delaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 TAX L. REV. 111, 117 (2013); Gideon Yaniv, *Tax Compliance and Advance Tax Payments: A Prospect Theory Analysis*, 52 NAT'L. TAX. J. 753, 754–62 (1999).

¹²⁶ Elffers & Hessing, *supra* note 125, at 290; Yaniv, *supra* note 125, at 754–55.

¹²⁷ The research shows a more nuanced relationship between compliance, advance payments, tax receipts, and taxpayers' perceptions of audit risk, but the framing effect is still of consequence. See Elffers & Hessing, *supra* note 125, at 290–91; Yaniv, *supra* note 125, at 754–56.

¹²⁸ McCaffery & Baron, *supra* note 81, at 117–19.

¹²⁹ *Id.* at 114–15.

¹³⁰ Edward J. McCaffery & Joel Slemrod, *Toward an Agenda for Behavioral Public Finance*, in MCCAFFERY & SLEMROD, *supra* note 41, at 12–13.

¹³¹ Edward J. McCaffery, *Behavioral Economics and the Law: Tax*, in THE OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND THE LAW 599, 609 (Eyal Zamir & Doron Teichman eds., 2014); McCaffery & Baron, *supra* note 81, at 120–24.

¹³² Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. OF ECON. PERSP. 193, 194–97 (1991).

¹³³ See Shu et al., *supra* note 113 at 15197–200.

¹³⁴ See generally McCaffery, *supra* note 131, at 609–10 (mentioning factors that can influence an individual's perception of taxes).

III. USE TAXES

The prior discussion evidences that the tax-compliance puzzle is complicated. There are many motivators of tax compliance, but the precise contours and relationship between those factors require further understanding. This Article argues that the use-tax gap provides an excellent forum for applying the various models of tax compliance to assist in that quest. Before undertaking the task of identifying particular strategies, though, it is important to first understand the role and structure of use taxes, the current use-tax gap, and the research that has been done on that gap to date.

To begin, the term “tax gap” refers to the gap between the tax that is owed to a government and the tax that is paid on time or that is ultimately remitted. The gap generally represents taxpayers’ failures to voluntarily comply with their tax obligations, though some of that failure is due to simple oversight or factors precluding compliance.¹³⁵ It is difficult to precisely measure the tax gap because the government is unable to know precisely how much tax is owed. Taxpayer obfuscation, ignorance, and the so-called “black market” serve as significant obstacles to both tax compliance and tax-gap estimation. Using various techniques, however, the IRS calculates an estimated gross federal tax gap that is roughly \$450 billion a year.¹³⁶ The vast majority of that tax gap is attributable to underreported tax, though some of the tax gap is also attributable to taxpayers who do not file their taxes or who underpay the tax that is reported as owed.¹³⁷ Notwithstanding that noncompliance, the IRS estimates an overall voluntary compliance rate of roughly 83%.¹³⁸

The story is much different for state use taxes. Compliance with those taxes is essentially nonexistent outside of business taxpayers and the payment of taxes on purchases where collateral enforcement mechanisms are in place (consider automobile purchases, which require payment of the tax before the state will license the vehicle). To better understand the source of this widespread noncompliance, Part III.A summarizes the history and structure of state use taxes and the legal and practical issues that have contributed to the use-tax gap. Section III.B then introduces the limited efforts that states have taken to address that gap at the state level, and section III.C discusses the existing academic research on use-tax

¹³⁵ Estimating the tax gap is difficult given the lack of reliable information, and scholars have adopted a number of techniques to make their own measurements. Alm, *supra* note 24, at 60–62.

¹³⁶ *Tax Gap 2006*, *supra* note 28. The gross tax gap is the gap between the amount of tax that is owed and the amount of the tax that is paid timely and voluntarily. The IRS estimates a “net” tax gap of \$385 billion per year. *Id.* The net tax gap is the difference between the amount of tax owed and the amount ultimately collected. *Id.*

¹³⁷ *Id.* at 1.

¹³⁸ *Id.* at 2. Noncompliance is largely attributable to underreported business income of self-employed individuals. *See id.* at 2.

compliance. Together, these sections comprehensively assess where we are and what we know about the state use tax.

A. *The Use-Tax Gap*

States have imposed sales taxes since the 1930s.¹³⁹ Those taxes are imposed on consumers who purchase taxable property and services and are generally collected by merchants at the point of sale.¹⁴⁰ Using merchants to collect the tax, however, means that purchasers can avoid the tax by purchasing goods from a merchant—perhaps a vendor in a neighboring state—who does not collect that tax. As a consequence, every state with a sales tax also has a compensating use tax, which is owed when a purchaser uses property in the state but did not pay sales tax at the point of sale.¹⁴¹ Consumers are required to voluntarily remit the required sums of use tax directly to the state, but very few have historically done so.¹⁴²

Of course, states have always understood that relying on consumers to voluntarily remit use taxes would be less effective than simply requiring out-of-state vendors to collect that tax on their behalf. States thus experimented with statutes requiring remote vendors to do just that. Those vendors were understandably resistant to those obligations and challenged them as violating the U.S. Constitution.¹⁴³ The Supreme Court ultimately responded in favor of remote vendors by determining that states could exercise their taxing power only over vendors who had a physical presence within their boundaries.¹⁴⁴ The Court last addressed and affirmed its physical-presence rule in 1992 in *Quill Corp. v. North Dakota*,¹⁴⁵ but that rule has gained more prominence in today's world given the emergence and

¹³⁹ See HELLERSTEIN, *supra* note 10, ¶ 12.02.

¹⁴⁰ *Id.* ¶ 12.04.

¹⁴¹ The use tax technically also applies anytime a purchaser pays sales tax to the merchant, but at a rate lower than the rate of tax in her jurisdiction of use. This is because the state of use will tax that use, but grant a credit against that tax for the amount of tax paid in the other jurisdiction. See HELLERSTEIN, *supra* note 10, ¶ 18.08. This particular aspect of the use tax is problematic from a compliance perspective, but will not be addressed separately herein. See generally Adam B. Thimmesch, *Taxing Honesty*, W. VA. L. REV. (forthcoming 2015) (manuscript at 5) (on file with the Utah Law Review) (discussing a number of additional situations in which the use tax applies to consumers).

¹⁴² See Scott W. Gaylord & Andrew J. Haile, *Constitutional Threats in the E-Commerce Jungle: First Amendment and Dormant Commerce Clause Limits on Amazon Laws and Use Tax Reporting Statutes*, 89 N.C. L. REV. 2011, 2025 (2011) (noting that “use tax compliance has been extremely low historically”).

¹⁴³ See generally HELLERSTEIN, *supra* note 10, ¶ 19.02 (outlining the legal challenges that ultimately led to the Court's physical-presence rule).

¹⁴⁴ *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 758 (1967) (“But the Court has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the U.S. mail.”).

¹⁴⁵ 504 U.S. 298 (1992).

importance of electronic commerce (“e-commerce”).¹⁴⁶ Many online vendors do not have physical presences in the states where their customers are located, and they are thus freed from the burden of collecting taxes in those states. Of course, consumers still owe their states’ use taxes on those purchases, but compliance with that requirement is virtually nonexistent.

Unfortunately, there is little formal data on use-tax compliance across the United States, but a study recently performed by the Research Department of the Minnesota House of Representatives¹⁴⁷ provides valuable insight. That study reports data obtained for the tax year 2012 from the twenty-seven states that collect use tax on their income-tax returns.¹⁴⁸ In that year, eighteen of those states reported that less than 2% of returns reported any use tax due.¹⁴⁹ Only two states had participation rates above 5%—Maine and Vermont. Maine’s participation rate of 10.2% was significantly higher than the overall rates reported, but researchers noted that the state had undergone a compliance campaign in 2006 and had an earlier practice of assessing liabilities for taxpayers who left the use-tax line on their tax returns blank.¹⁵⁰

The average reporting rate in the sampled states was approximately 1.9%.¹⁵¹ The average amount of tax reported ranged from \$39 in Pennsylvania to \$876 in Connecticut.¹⁵² Notably, the data show that states see “significant increases in collections” when they place lines on their income-tax returns for taxpayers to report their use-tax liabilities.¹⁵³ Thirteen states in the study also provided taxpayers with lookup tables to estimate their tax liabilities, and the participation rate in those states was 2.2% versus a participation rate of 1.3% in states without such tables.¹⁵⁴ Interestingly, although the participation rate was higher in states with lookup tables, the average amount of tax reported was actually lower in those states.¹⁵⁵

¹⁴⁶ Overall, e-commerce in the United States exceeds \$70 billion per quarter and represents approximately 6% of total retail commerce in the United States. Press Release, U.S. Census Bureau News, Quarterly Retail E-Commerce Sales 3rd Quarter 2014 (Nov. 18, 2014), http://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf, *archived at* <http://perma.cc/D354-XWP5>.

¹⁴⁷ Nina Manzi, Minn. House of Representatives Research Dep’t, Use Tax Collection on Income Tax Returns in Other States 7 (April 2015), *available at* <http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf>, *archived at* <http://perma.cc/2VLA-F7C7>.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 8.

¹⁵¹ *Id.* at 10.

¹⁵² *Id.* at 7. The Connecticut numbers are much higher than other states. The next highest average amount reported per return was \$154 in California. *Id.*

¹⁵³ *Id.* at 8.

¹⁵⁴ *Id.* at 9–10.

¹⁵⁵ *Id.* at 11.

These data show that compliance numbers are indeed small. The numbers reported in the study represent data from states where the tax issue is presented to taxpayers directly on their income-tax return. Presumably, compliance is even lower in states where taxpayers must take the affirmative step of seeking out an unfamiliar use-tax return to report and pay their tax. We could thus presume a participation rate of effectively zero in those states.

This low level of compliance is costly. The sales-tax revenue lost due to e-commerce alone is estimated to be approximately \$12 billion annually.¹⁵⁶ Adding in the lost revenue from catalogue sales takes this number to nearly \$20 billion annually.¹⁵⁷ States would thus benefit immensely from the reversal of the physical-presence rule by either the Supreme Court or Congress, but neither has acted to modify the rule. States are making progress, however, toward obtaining passage of a federal bill that would allow them to require remote vendors of a certain size to collect and remit their taxes. The most recent vehicle for that approach was the Marketplace Fairness Act of 2013.¹⁵⁸ The Senate passed that bill in early 2013, but the House failed to take action on the legislation.¹⁵⁹ In 2014, commentators were more optimistic that the House would revise the bill to appeal to more conservatives,

¹⁵⁶ BRUCE ET AL., *supra* note 11, at ii. The study gave two estimates—one based on a “baseline” growth estimate and one based on an “optimistic” growth estimate. *Id.* The estimated losses were \$11.4 billion and \$12.65 billion, respectively. The magnitude of these estimated revenue losses is not without debate. *See, e.g.*, Noah Aldonas, *DOR Disputes E-Commerce Sales Tax Loss Estimates*, 65 ST. TAX NOTES 576, 576 (2012) (noting statements by Nebraska’s then-Tax Commissioner that the Bruce and Fox estimates of lost use-tax revenue from e-commerce sales were significantly overstated); Joseph Henchman, *Internet Sales Tax Collections Falling Far Short of Experts’ Estimates*, TAX FOUND.: THE TAX POL’Y BLOG (March 18, 2013), <http://taxfoundation.org/blog/internet-sales-tax-collections-falling-far-short-experts-estimates>, archived at <http://perma.cc/R7LL-KK4U> (noting that the \$11 billion estimate related to e-commerce is “far off” and “probably overstated by four- or five-fold”); Laura Mahoney et al., *States See Little Revenue from Online Sales Tax Laws, Keep Pressure on Congress*, BLOOMBERG BNA: DAILY TAX REP. (Jan. 8, 2014), available at <http://www.bna.com/states-little-revenue-n17179881226/>, archived at <http://perma.cc/8PYD-E2PF> (noting that other studies have estimated the annual losses at \$3.9 billion and \$3.55 billion per year). These critiques often rely on recent experiences in states where vendors have started to collect use taxes to show that scholars’ estimates are overstated. It is thus fair to question the exact magnitude of the uncollected use tax, but it is too early to tell whether current estimates are incorrect. *See* Billy Hamilton, *Fox and Friends: The Rest of the Story on E-Commerce Tax Loss Estimates*, 68 ST. TAX NOTES 535, 535–40 (2013) (discussing potential reasons that states’ collections may not match academic estimates).

¹⁵⁷ *See supra* note 15 and accompanying text.

¹⁵⁸ 159 CONG. REC. S3069–3085 (May 6, 2013) (citing S. 743, 113th Cong. (2013); H.R. 684, 113th Cong. (2013)).

¹⁵⁹ Henry J. Reske, *U.S. House Judiciary Committee Mum on New Draft of Marketplace Fairness Act*, 71 ST. TAX NOTES 341, 341 (2014).

but it took no action beyond a House Judiciary Committee hearing.¹⁶⁰ In early 2015, a new version of the Marketplace Fairness Act (the “Act”) was introduced in the Senate.¹⁶¹ That version is fundamentally the same as the 2013 version, but has a delayed effective date.¹⁶²

A full discussion of the Act is beyond the scope of this Article, but a couple of key points should be noted. First, the Act would not give states blanket authority to require remote vendors to collect their taxes. A state’s laws must conform to a number of simplifying provisions before a state could obtain the benefits of the Act.¹⁶³ States that are unwilling or unable to do so would not be afforded the protection of the Act. Second, the Act contains a “small seller” exception that would significantly limit its grant of authority.¹⁶⁴ That exception applies to protect those vendors who make no more than \$1,000,000 in remote sales in a year.¹⁶⁵ Unless a vendor’s remote sales exceed that threshold, the Act would not grant states authority to impose obligations on that vendor.

The impact of the small-seller exception should not be understated. The vast majority of online retailers in the United States have sales that fall below the \$1,000,000 threshold, and the impact of that small-seller exception is that less than 0.1% of online retailers would be required to collect tax.¹⁶⁶ Further, although the sales of those “large” retailers represent approximately 57.3% of total U.S. retail electronic commerce,¹⁶⁷ many of those retailers are already collecting sales tax in many states. As a result, researchers estimate that the Act, with the current small-seller exception, would close less than one-half of the use-tax gap.¹⁶⁸ That number does not take into account the additional revenue that may escape taxation when

¹⁶⁰ Press Release, U.S. H.R. Judiciary Comm., House Judiciary Committee to Hold Hearing on the Internet Sales Tax Issue (Mar. 10, 2014), *available at* <http://judiciary.house.gov/index.cfm/2014/3/house-judiciary-committee-to-hold-hearing-on-the-internet-sales-tax-issue>, *archived at* <http://perma.cc/98ML-SLPS>; *H.R. 684 (113th): Marketplace Fairness Act of 2013*, GOVTRACK.US, <http://www.govtrack.us/congress/bills/113/hr684>, *archived at* <http://perma.cc/8K8U-4YAZ> (last visited June 5, 2015) (showing that the House version of the Marketplace Fairness Act was referred to committee on February 14, 2013 and has not emerged).

¹⁶¹ S. 698, 114th Cong. (2015). House Republicans have also circulated drafts of competing bills, but those drafts rely on origin sourcing and are heavily critiqued by those in the tax community. *See* John A. Swain, *Reconciling the Marketplace Fairness Act and Origin Sourcing*, 75 ST. TAX NOTES 809, 809 (2015); Maria Koklanaris, *NCSL Blasts Goodlatte for Hybrid Origin-Sourcing Proposal*, 75 ST. TAX NOTES 251, 251 (2015).

¹⁶² S. 698, 114th Cong. § 3(h) (2015).

¹⁶³ *Id.* § 2.

¹⁶⁴ *Id.* § 2(c).

¹⁶⁵ *Id.*

¹⁶⁶ BRUCE & FOX, *supra* note 19, at 4.

¹⁶⁷ *Id.* at 4–5.

¹⁶⁸ *Id.* at 40.

consumers shifted their shopping to retailers that were protected by the small-seller exception.¹⁶⁹

Recognizing the revenue-limiting impact of the small-seller exception is critically important. Even if the Act is passed, states will need to develop a different approach if they want to collect the use taxes that are due.

B. Existing Efforts to Close the Use-Tax Gap at the State Level

Thus far, states have largely failed to take meaningful efforts to encourage voluntary compliance with their use taxes.¹⁷⁰ Many accept that inaction because those taxes seem unenforceable. Each individual consumer owes relatively little in tax, so enforcing the tax through individual audits seems unadvisable if looking at the direct return on investment.¹⁷¹ This is especially true when enforcement dollars are scarce. States have, however, recently taken two different approaches worthy of note.

First, as discussed above, many states have included use-tax lines on their income-tax returns. Use tax has historically been paid on a separate use-tax return, which is familiar for business taxpayers who pay sales and use taxes regularly, but is likely completely unknown to most individuals. States realized that incorporating use-tax payments into the income-tax return process would increase compliance through salience, if nothing more. Twenty-seven states thus currently include a use-tax line item on their individual income-tax returns.¹⁷²

Implementation of this method has taken different forms. Some states provide a line item on their return and nothing more, some provide tables for taxpayers to

¹⁶⁹ Recent research suggests that individuals respond to the collection of use tax by online vendors by shifting their purchasing to vendors who do not collect that tax. *E.g.*, Einav et al., *supra* note 20, at 2 (explaining “how [eBay] consumers shift their purchasing across states and between offline and online retail in response to state sales taxes”); Baugh et al., *supra* note 20, at 3 (showing “that Amazon experience[d] a dramatic decline in sales following the implementation of an Amazon Tax”).

¹⁷⁰ See Mike Maciag, *Use Tax Revenues: How Much Are States Not Collecting*, GOVERNING (May 1, 2012), <http://www.governing.com/blogs/by-the-numbers/state-use-tax-collection-revenues.html>, archived at <http://perma.cc/HX8X-Z2UV> (“States rarely pursue those who skirt use tax obligations” and that “[t]argeting use tax cheats is largely impractical”). There are exceptions to this general apathy toward use-tax payment and enforcement. See Thimmesch, *supra* note 141, at 11–13 (discussing several situations in which use taxes are enforced).

¹⁷¹ Manzi, *supra* note 147, at 4 (“States have historically viewed the use tax on individuals as impractical to enforce—the tax typically involves small amounts owed on a large number of transactions for which the individual has not kept records, and the costs of collection could easily exceed the revenues collected.”); Phillip W. Gillet, Jr., *Privacy Issues May Add to the Debate Over State Taxation of E-Commerce*, J. MULTISTATE TAX’N, Sept. 2001, at 13, 16 (“One problem with use taxes is that enforcement on buyers is such a logistical nightmare that states rarely actively enforce their use tax provisions.”).

¹⁷² Manzi, *supra* note 147, at 2.

use to find an average amount of tax due, and some require taxpayers to specifically write “zero” in the use-tax line if they are reporting no use-tax liability.¹⁷³ The State of Michigan has gone one step further, and provides a warning to taxpayers when they access the state’s income-tax return online.¹⁷⁴ The state’s webpage displays a warning that states if the taxpayer reports “zero” on the use-tax line, she is “certifying that no USE TAX is owed.”¹⁷⁵ The warning then notes that “[i]f it is determined that Use Tax is owed, the taxpayer will be liable for the deficiency as well as interest and may be subject to penalty.”¹⁷⁶ Despite the ragged nature of these approaches, they have been somewhat successful, in that they have generated *some* revenue.¹⁷⁷ However, overall compliance rates even in those states are shockingly low.¹⁷⁸ Recent data show that the percentage of returns reporting use tax in states where there is a line item on the income-tax return ranges from 0.2% to 10.2%.¹⁷⁹ Those data are skewed by states with reporting percentages significantly above the average. As noted above, average compliance in states without a lookup table is 1.3% and is 2.2% in states with a lookup table.¹⁸⁰

The other major state effort to collect use taxes from individual taxpayers has been the implementation of information-reporting systems with respect to remote purchases. Those efforts started with Colorado in 2010 when the state adopted a unique statute that imposes three different obligations on retailers who sell to consumers in the state but who do not collect and remit the state’s sales or use taxes. The first is a transaction-based notice that vendors are required to provide to Colorado purchasers during the course of their purchase transaction.¹⁸¹ That notice informs consumers of the existence of the state use tax and their responsibility for paying that tax.¹⁸² The second is an annual report that vendors must send to consumers to summarize their annual purchase activity from that vendor.¹⁸³ The third is an annual statement that must be mailed to the Colorado Department of

¹⁷³ *Id.* at 8–10; *see, e.g.*, MASS. GEN. LAWS. ch. 64I, § 4A (2010) (allowing the payment of tax based on an “estimated liability” table except for purchases of single assets with a sales price of \$1,000 or greater).

¹⁷⁴ 2013 *Michigan Individual Income Tax Return MI-1040*, MICH. DEP’T OF TREASURY (Oct. 2013), *available at* http://www.michigan.gov/documents/taxes/MI-1040_442214_7.pdf, *archived at* <http://perma.cc/UN25-SZDS>.

¹⁷⁵ *Id.* The pop-up box containing these statements is initiated when the website is accessed. A copy of the text is included below. This approach is obviously remarkable.

¹⁷⁶ *Id.* The pop-up box containing these statements is initiated when the website is accessed.

¹⁷⁷ Manzi, *supra* note 147, at 7 tbl.1.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* at 13 tbl.3.

¹⁸⁰ *Id.* at 14.

¹⁸¹ COLO. REV. STAT. § 39-21-112(3.5)(c)(I) (2014).

¹⁸² *Id.*

¹⁸³ *Id.* at § 39-21-112(3.5)(d)(I)(A); COLO. CODE REGS. § 39-21-112-3.5(3)(a), (c) (2009).

Revenue.¹⁸⁴ That statement informs the state of taxpayers' total annual purchases from the vendor.¹⁸⁵ This scheme has been the subject of a constitutional challenge since shortly after its enactment, and that litigation is currently ongoing.¹⁸⁶

A number of states have adopted similar, but less extensive, reporting laws.¹⁸⁷ Those laws are notable in that they require only a point-of-sale notification.¹⁸⁸ They do not require vendors to send annual summaries to consumers or to the state. Thus, although they are similar in that they seek to increase the salience of the use tax, they do not take complete advantage of the information-reporting aspects of the Colorado law.

Beyond these limited activities, states have done very little to systematically encourage knowledge of or compliance with their use taxes.¹⁸⁹ Some states have information pages on their websites and some have sent out informational mailings, but those approaches appear to have been of limited scope and not ongoing. For example, the Alabama Department of Revenue recently sent letters to taxpayers who left the use-tax line item on their income tax return blank.¹⁹⁰ At one point, approximately a third of taxpayers who received the letters subsequently reported and paid tax,¹⁹¹ but the state abandoned the program.¹⁹² Indiana, Massachusetts, and Rhode Island have also sent informational letters to taxpayers in recent decades.¹⁹³ In 2006, Maine went further and initiated a compliance program that included letters, television advertisements, and a safe harbor that eliminated interest on past-due liabilities.¹⁹⁴ That effort increased tax reporting approximately three-fold in the

¹⁸⁴ COLO. REV. STAT. § 39-21-112(3.5)(d)(II)(A); COLO. CODE REGS. § 39-21-112-3.5(3)(a), (c).

¹⁸⁵ COLO. REV. STAT. § 39-21-112(3.5)(d)(II)(A).

¹⁸⁶ On March 3, 2015, the U.S. Supreme Court ruled that a challenge to the Colorado legislation in federal court was not barred by the Tax Injunction Act and remanded the case to the Tenth Circuit for further consideration. *Direct Marketing Association v. Brohl*, 135 S.Ct. 1124 (2015).

¹⁸⁷ *E.g.*, KY. REV. STAT. ANN. § 139.450 (LexisNexis 2006); OKLA. STAT. tit. 68, § 1406.1 (2001); S.C. CODE ANN. § 12-36-2691(E) (2012); S.D. CODIFIED LAWS § 10-63-2 (Supp. 2013); VT. STAT. ANN. tit. 32, § 9783 (2013).

¹⁸⁸ KY. REV. STAT. ANN. § 139.450(2)(a); OKLA. STAT. tit. 68, § 1406.1; S.C. CODE ANN. § 12-36-2691(E)(1); S.D. CODIFIED LAWS § 10-63-2; VT. STAT. ANN. tit. 32, § 9783(b).

¹⁸⁹ The State of North Carolina has taken the discussed approaches and also unsuccessfully attempted to gather its residents' purchasing information directly from Amazon.com. *See* Gaylord & Haile, *supra* note 142, at 2025–39 (discussing the state's attempts to collect use tax and its litigation with Amazon.com over consumer information).

¹⁹⁰ Martin Swant, *State of Alabama Sending Tax Notices to Some Consumers for Online, Out-of-State Purchases*, BIRMINGHAM NEWS (Sept. 8, 2010, 10:00 AM), http://blog.al.com/businessnews/2010/09/state_of_alabama_sending_tax_n.html, archived at <http://perma.cc/D96X-AACY>.

¹⁹¹ *Id.*

¹⁹² Maciag, *supra* note 170.

¹⁹³ Manzi, *supra* note 147, at 9.

¹⁹⁴ *Id.* at 8–9.

years after the program.¹⁹⁵ The state ran another compliance program in 2012, but did not see as significant of revenue gains.¹⁹⁶ To be sure, then, states have taken some efforts to promote use-tax compliance, and those efforts have had some success. Unfortunately, however, the programs are generally limited in scope and duration and fail to fully explore the motivators of use-tax compliance. Current data also reflect that previous compliance efforts have failed to have long-standing effect. Among the states mentioned in this paragraph, compliance is currently meaningfully higher than the average only in Maine.¹⁹⁷

This analysis cannot ignore that there may be political reasons for states to fail to enforce their use taxes. The political aversion to tax increases is well known, and Republican politicians may find it better to simply let this revenue source stay dormant. Discussion of the Act shows that many individuals view use taxes as “new” taxes, and enforcement activity could be seen as a violation of an anti-tax pledge.¹⁹⁸ Of course, this does not excuse a system of taxation where consumption in local stores is subject to tax while consumption from certain remote vendors is exempt. If there are revenue concerns from enforcing the use tax, those should be addressed directly rather than maintaining an illogical system of preference toward commercial activity with vendors with certain business structures. This also says nothing about the distributional aspects of allowing wealthy consumers to avoid the tax by shopping online while those without access to reliable Internet, credit, or a stable address pay local sales taxes.¹⁹⁹

C. Existing Research on Use-Tax Compliance

The materials above establish that states have taken little effort to promote use-tax compliance by their taxpayers. Unfortunately, academic analyses and

¹⁹⁵ Tom Porter, *Maine Tax Amnesty Initiative Fails to Deliver Expected Revenues*, THE ME. PUB. BROAD. NETWORK (Nov. 29, 2012), <http://www.mpbnet.net/News/MPBNNews/tabid/1159/ctl/ViewItem/mid/3762/ItemId/24924/Default.aspx>, archived at <http://perma.cc/P3EQ-6ZSC> (stating that use-tax reporting on individual income-tax returns rose from approximately \$1 million to \$3 million per year after the 2006 program).

¹⁹⁶ *Id.* The state raised \$7 million of revenue from its 2006 program and roughly \$1 million from the 2012 program. *Id.*

¹⁹⁷ See Manzi, *supra* note 147, at 13, table 3 (reporting a participation rate of 1.3% in Alabama, 0.9% in Indiana, 0.8% in Kentucky, 10.2% in Maine, and 1.8% in Massachusetts).

¹⁹⁸ See *Conservatives Oppose the So-Called Marketplace Fairness Act*, THE HEARTLAND INST., <http://heartland.org/no-net-tax>, archived at <http://perma.cc/P2PY-W3NB> (last visited Sept. 18, 2015) (compiling statements advocating against the Marketplace Fairness Act for reasons including that it would represent a tax increase).

¹⁹⁹ See Thimmesch, *supra* note 141, at 15 (addressing the variety of equitable concerns presented by use-tax nonenforcement).

experimentation with respect to that tax have been just as, if not more, sparse. There have, however, been a few studies and experiments to consider.²⁰⁰

One recent study looked at the impact of a use-tax amnesty program offered in Illinois and the modification of that state's personal income-tax return to include a use-tax line item.²⁰¹ The result of those actions was a meaningful percentage increase in use-tax reporting, but not compliance by a significant part of the population.²⁰² Illinois saw the number of returns reporting use tax rise from approximately 8,000 in 2009 to more than 240,000 in 2010.²⁰³ The increased filings, however, represented only approximately 4.5% of returns in Illinois.²⁰⁴ The researchers recognized that increased knowledge of the tax might have been responsible for increased reporting, but they felt that the overall low levels of compliance suggested that it was "probably more plausible" to attribute the lack of compliance to the lack of enforcement rather than to a lack of knowledge.²⁰⁵

Some other findings from the study are particularly worthy of note. First, the majority of taxpayers reporting use taxes reported the exact amount of tax as the estimate provided on the state's lookup table.²⁰⁶ This may suggest that compliance increased simply because the state reduced the administrative costs of compliance. It is also interesting to note, however, that the instructions to the state's income-tax return included a statement in the use-tax section that "[w]e conduct routine audits based on information received from third parties, including the U.S. Customs Service and other states."²⁰⁷ It is thus possible that there was a deterrent effect that caused the increase in compliance as well.²⁰⁸

Other observations relevant to this Article include that taxpayers were actually *less* likely to pay the tax if they used a tax-return preparer.²⁰⁹ Also, the researchers found no relationship between the taxpayer's "tax position" (i.e., whether they owed tax or were owed a refund) and whether they reported use tax.²¹⁰ This is interesting

²⁰⁰ This section focuses on published studies with respect to use-tax compliance by individual taxpayers. Studies that evaluate use-tax compliance by businesses address a related, but separate question, and are not addressed herein. See Govind S. Iyer et al., *Increasing Tax Compliance in Washington State: A Field Experiment*, 63 NAT'L TAX J. 7, 14–17 (2010) (evaluating a field experiment on the payment of use taxes by businesses in the construction industry).

²⁰¹ See Joanna Koh et al., *Factors Influencing Use Tax Payment in Illinois* 153–54 (2014), available at <http://www.irs.gov/pub/irs-soi/13rescontaxpayment.pdf>, archived at <http://perma.cc/WGW8-CAPD>.

²⁰² See *id.* at 159.

²⁰³ *Id.*

²⁰⁴ See *id.* at 157–58.

²⁰⁵ *Id.* at 154, 160.

²⁰⁶ *Id.* at 159.

²⁰⁷ *Id.* at 160 n.22.

²⁰⁸ See *supra* note 34 (providing a list of sources discussing the impact of third-party reporting on tax compliance).

²⁰⁹ Koh et al., *supra* note 201, at 160.

²¹⁰ See *id.* at 165.

when evaluating the potential impact of the behavioral-economics concepts discussed above, which might suggest that taxpayers who are owed a refund may be more likely to report use tax because it would be framed as a reduction of a gain rather than as a loss.²¹¹ Of course, this is not to say that the results disproved the impact of loss aversion. How taxpayers frame gains and losses is unclear, and it could be simply that taxpayers viewed use-tax payments as losses in any event.

Experimental results from a study conducted with participants in Illinois and Florida are also instructive. That study examined two methods for potentially increasing use-tax compliance—allowing consumers to pay the tax voluntarily at the point of sale (an “effort remedy”) and providing consumers with information about the tax (an “information remedy”).²¹² The survey was designed such that the two methods were tested in isolation from one another and also in conjunction with one another. The participants in the study were all asked to make a purchase from a fictitious online vendor and to estimate the likelihood that they would pay use tax on the purchase.²¹³ They were also asked to rate their level of knowledge of the use tax on a scale from 1 (no knowledge) to 7 (very high knowledge).²¹⁴ The researchers then tabulated the results and determined which, if any of the treatments, increased compliance.

Looking first at taxpayer knowledge, participants in the study reported little familiarity with the use tax. Nearly 66% of the participants in Florida and approximately 37% of the participants in Illinois reported having absolutely no knowledge of the tax, and less than 2% of participants in Florida and 11% of participants in Illinois reported a high level of knowledge of the tax.²¹⁵ These low levels of knowledge are critically important when analyzing how to increase use-tax compliance. One cannot comply with a tax that is unknown if the payment must be made through affirmative action by the taxpayer.²¹⁶

²¹¹ See *supra* Section II.B.3 (discussing framing effects and behavioral economics).

²¹² See Christopher R. Jones & Yuyun Sejati, *Improving Use Tax Compliance by Decreasing Effort and Increasing Knowledge*, 11 ATA J. LEGAL TAX RES. 1, 2–3, 7–8 (2013).

²¹³ *Id.* at 8. Those receiving the effort-remedy treatment were also given the option of reporting and paying the tax at the point of sale. *Id.* at 5

²¹⁴ *Id.* at 10.

²¹⁵ *Id.* The authors of the study opined that the differences in knowledge could be attributed to the fact that Illinois requires the reporting of use tax on its income-tax return. See *id.* at 9. Florida has no income tax, so the state cannot increase knowledge of the tax through that method.

²¹⁶ These results are consistent with other studies showing that knowledge of the use tax is incredibly low. See *Two-Thirds of Consumers Are Confused by Online Sales-Tax Compliance*, CENTER OF SHOPPING (July 28, 2011), <http://www.thecenterofshopping.com/blog/two-thirds-of-consumers-are-confused-by-online-sales-tax-compliance>, archived at <http://perma.cc/NV3V-F2PT>; Geoffrey Propher, *Use Tax Awareness and Compliance: A Survey Analysis*, 65 ST. TAX NOTES 257, 258 tbl.1 (July 23, 2012).

The results of the treatments in the study are also instructive. The use of both treatments in conjunction resulted in a self-reported compliance rate of 61% in Florida and 87% in Illinois.²¹⁷ Participants who received only the effort remedy reported compliance at the rate of 48% in Florida and 76% in Illinois.²¹⁸ The application of the information remedy alone caused reported compliance at a rate of 25% in Florida and 28% in Illinois.²¹⁹ When none of the treatments were applied, compliance rates were 21% in Florida and 41% in Illinois.²²⁰

These data are interesting in several respects. First, the participants either significantly overstated the extent of their compliance, or they were not a representative sample of the population. Nearly 7% of Florida participants and nearly 22% of Illinois participants reported having paid use tax before the study.²²¹ Additionally, in the study itself, 21% of the Florida participants and 41% of the Illinois participants who received no treatment reported that they would pay the use tax.²²² As discussed above, however, real-world compliance rates are nowhere near those levels.²²³ Specifically, we know that actual compliance rates in Illinois were less than 5% after the use-tax line item was included on the state's income-tax return.²²⁴ We can thus fairly question the overall utility of the results of the study.²²⁵

Notwithstanding these problems, there are still many noteworthy results from the study. First, it is interesting that the application of both remedies, in conjunction with one another, had more impact than the application of either alone. Second, the application of the effort remedy alone had more impact than the application of the information remedy alone. Finally, the Illinois participants actually reported a *lower* likelihood of compliance after having received the information treatment than when receiving no treatment at all.²²⁶ Stating that final result in another way, receiving information about the use tax actually caused fewer Illinois participants to report that they would pay the tax. This result is in conflict with the actual experience of

²¹⁷ Jones & Sejati, *supra* note 212, at 12 tbl.4.

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.* at 10 tbl.2.

²²² *Id.* at 12 tbl.4.

²²³ The participants in the study included 122 undergraduate and graduate business students in Florida and a total of 110 faculty members, college staff, and graduate and undergraduate students in Illinois. *Id.* at 8. It is possible that use-tax compliance among those groups is meaningfully higher than among the general population and that these survey results are thus not out of line with observed compliance in the real world. Unfortunately, however, the data that have been compiled on use-tax compliance are not that granular (or have not been reported as such), so we cannot currently assess that possibility.

²²⁴ See Koh et al., *supra* note 201, at 158.

²²⁵ The authors also recognize that the participants may have misrepresented the extent to which they would comply. Jones & Sejati, *supra* note 212, at 15 n.21.

²²⁶ *Id.* at 12, tbl.4.

Illinois after it engaged in efforts to increase the salience of its tax,²²⁷ but is remarkable. States and researchers should be cognizant of this result as they work to increase use-tax compliance through affirmative efforts in the field.

Another recent laboratory experiment evaluated the relationship between use-tax compliance, social norms, and states' enforcement efforts.²²⁸ The researcher surveyed a group of 245 college business students regarding their views on why they comply with their use-tax obligations, how they felt about paying those taxes, their beliefs on how others felt about paying those taxes, their understanding of states' enforcement efforts and penalties for use-tax noncompliance, and their personal use-tax reporting behavior.²²⁹ The study found that the participants were more likely to have paid use tax based on their own internal pressures than on the external enforcement pressures imposed by states. However, perceptions of audit probability and sanction severity did positively impact compliance.²³⁰ The author thus recommended that states interested in increasing use-tax compliance focus their efforts on enhancing residents' trust of the taxing authority and on increasing "service-oriented interaction[s]" with taxpayers rather than increasing audits and penalties.²³¹

Despite the relevance of the results from this experiment, we must again be mindful of the study's limitations. First, participants in the study were drawn from one particular segment of the population—college students studying business.²³² Additionally, we are unable to judge the veracity of the participants' responses by comparing them to existing compliance data because the study did not provide the raw data on participants' reported use-tax compliance. However, our ability to draw broad inferences from the study would be questionable either way. If a significant percentage of participants reported having paid the tax, we would necessarily be suspicious of their answers. In contrast, if an expected amount (less than 10%) reported having previously paid the tax, the data on the motivators of existing compliance would be gathered from fewer than 25 people. The conclusions that could be drawn from that sample size are thus limited, at best.²³³ Finally, it should be unsurprising that the participants who reported paying use tax were more likely to have done so due to internal norms rather than due to external enforcement efforts.

²²⁷ See *supra* text accompanying notes 201–211.

²²⁸ Xin Liu, *Use Tax Compliance: The Role of Norms, Audit Probabilities, and Sanction Severity*, 18 ACAD. ACCT. & FIN. STUD. J. 65, 69–70 (2014).

²²⁹ *Id.* at 70–73.

²³⁰ See *id.* at 75.

²³¹ *Id.* at 76.

²³² *Id.* at 70.

²³³ Of course, it would again be helpful to know if real-world use-tax compliance is meaningfully higher within the group represented in this particular survey than within the general population, but that level of detail has not been reported in any use-tax study known to this author. The lack of that information adds to the difficulty of drawing general inferences from studies like the one discussed.

As noted herein, external enforcement efforts have been virtually nonexistent so they have not had an opportunity to induce compliance.

Another interesting study on use-tax compliance was conducted in conjunction with the Nebraska Department of Revenue.²³⁴ That study involved the mailing of postcards to one thousand taxpayers in the state.²³⁵ The postcards contained a statement reminding the recipients of a new line on the state income-tax return for reporting use-tax liabilities.²³⁶ The postcard also affirmatively encouraged taxpayers to report their use-tax liabilities.²³⁷ The income-tax returns filed by those taxpayers were then compared to a sample of returns filed by taxpayers who did not receive the communication.²³⁸

The data from the study showed that the provision of the postcards more than doubled the reporting rate from 0.7% of filers to 1.6% of filers.²³⁹ The percentage increase in reporting taxpayers was thus meaningful, but the nominal reporting rate was “still abysmally low.”²⁴⁰ The author of the study thus notes skepticism that a postcard nudge would have a meaningful impact and concludes that compliance efforts like the one used in the study “will fail to generate significant improvements in revenue collection.”²⁴¹

D. Summary

The use-tax gap is significant. Existing state efforts to close that gap have been focused on getting vendors to collect the tax at the point of sale, but those efforts have been largely unsuccessful. Further, even if states’ fortunes change and Congress passes the Marketplace Fairness Act, it does not appear as though more than half of the use-tax gap would be closed unless the small-seller exception is significantly modified or eliminated. How then can states get consumers to voluntarily pay that tax? Very little experimental research has been done specifically on use taxes, and that research has been of limited scope and is inconclusive. Additional efforts and research are thus warranted. The following section provides

²³⁴ John E. Anderson, *Paying the State Use Tax: Is a ‘Nudge’ Enough?* at *5 (unpublished manuscript) (on file with the Utah Law Review).

²³⁵ *Id.* at *4.

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.* at *7.

²⁴⁰ *Id.* Despite these results, it may be difficult to take any broad lessons from the study. Professor Anderson notes that the results were skewed because the taxpayers chosen to receive the postcards did not represent a representative sample of the population. *Id.* at *11 (reporting oversampling with respect to income level, filing status, and family size). Whether the experiment would have produced more meaningful results if the state had chosen a more representative sample of taxpayers is unknown.

²⁴¹ *Id.* at *14.

the foundation for those efforts by discussing the variety of ways in which the models of tax compliance could be used to address these issues.

IV. APPLYING THE MODELS OF TAX COMPLIANCE TO USE TAXES

Having reviewed the tax-compliance literature and the limited data on use-tax compliance, it is easy to see a number of factors that stand in the way of closing the use-tax gap. Taxpayer knowledge of the tax is very low, the costs of noncompliance are virtually nonexistent, and the effort for taxpayers to comply is high. The government has thus failed to establish any reason for taxpayers to believe in its competency to enforce the tax, and there has been no opportunity for a compliance norm to develop. Notwithstanding these problems, however, states must dedicate efforts to induce voluntary compliance if they want to close the use-tax gap.

The models of tax compliance discussed above fortunately provide us with a number of methods with which states could experiment. Of course, because there is no single model that predicts behavior for all taxpayers, states must consider a number of strategies. In this regard, it may be helpful initially to consider the different categories of noncompliant taxpayers. Those include taxpayers who do not comply because they are unaware of their obligations, those who do not comply because they do not feel that the penalties are sufficient to deter them, and those who do not comply simply because they do not wish to be the only fool paying the tax.²⁴² Each of these groups will respond to different stimuli, and therefore, a multitude of approaches must be considered.

The following materials set forth many ways that states could apply tax-compliance research to help generate consumer compliance with their use taxes, but is far from comprehensive. The intent of this section is not to set forth a complete plan for obtaining a use-tax compliance norm, but to illustrate that states have many available options. What is important is to recognize that the models of tax compliance can be applied in a multitude of ways, often in conjunction with one another, and in different forms by different states. The current acceptance of a noncompliant norm simply ignores the vast opportunities available in this area.

The following sections specifically discuss (A) how to increase consumer knowledge of the use tax in an effective and procedurally just manner, (B) how to economically deter use-tax noncompliance, and (C) how to appeal to taxpayers' nonpecuniary interests.

²⁴² See generally Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 LAW & POL'Y 3 (2007) (discussing the application of the concept of responsive regulation to tax administration and providing a pyramid approach to tax enforcement that recognizes the different motivational postures of taxpayers); Henk Elffers, *But Taxpayers Do Cooperate!*, in COOPERATION IN MODERN SOCIETY: PROMOTING THE WELFARE OF COMMUNITIES, STATES AND ORGANIZATIONS 184, 185–188 (Mark Van Vugt et al. eds., 2000) (setting out a “WBAD” model that takes into account the different categories of noncompliant taxpayers).

A. Information as the First Step for Use-Tax Compliance

As discussed above, knowledge of the use tax is very low. Thus, despite the apparent primacy of the deterrence model, states would likely benefit from first ensuring that use taxes and consumers' responsibilities with respect to those taxes are simply more salient. Knowledge of a tax is a necessary predicate to one's decision of whether to comply, and providing taxpayers with information is not only logical, but would comport with notions of procedural justice. Attempting to "shock" compliance through aggressive enforcement actions would likely be perceived as procedurally unjust and undermine citizens' beliefs regarding the legitimacy of government power.²⁴³

The biggest question for states with respect to increasing knowledge of the use tax is how to undertake such an educational campaign in a way that reaches a critical mass of taxpayers. States' efforts thus far have been of little effect, so new approaches are needed. One potential avenue that states could use to obtain wider knowledge of the tax is to leverage the attention recently given to the Marketplace Fairness Act. States should work to ensure that articles addressing that legislation (or its demise) specifically discuss consumers' responsibilities with respect to use taxes. Those stories would at least reach the segment of the population interested enough to read about that legislation.

²⁴³ See *supra* text accompanying notes 93–103. On these points, one need look no further than the IRS' recent experience with its voluntary disclosure program related to taxpayer reporting of foreign bank accounts on a form known as an FBAR, the Report of Foreign Bank and Financial Accounts. The IRS has undergone several rounds of so-called voluntary disclosure programs with respect to the FBAR, and the penalties under those programs have generally risen with each iteration of the program. See NAT'L TAXPAYER ADVOCATE, 2013 ANNUAL REPORT TO CONGRESS 228 (2013), available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Volume-1.pdf>, archived at <http://perma.cc/KPH3-FBTW> [hereinafter 2013 REPORT]. The programs offered reduced penalty exposure for individuals who had willfully failed to file the reports, but imposed more strict penalties than would have otherwise been faced by nonwillful violators. *Id.* Because of the threat of significant sanction, however, many individuals who were nonwillful violators felt compelled to participate rather than opt out and undergo a normal audit procedure. *Id.*; NAT'L TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 137 (2012), available at <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/downloads/Volume-1.pdf>, archived at <http://perma.cc/8L4C-KAEH>. The IRS Taxpayer Advocate noted the unfairness of the situation, which resulted in "benign actors" being treated less favorably than "bad actors." See 2013 REPORT, *supra*, at 232–33. She thus suggested several procedural steps to "improve[e] the fairness of the tax system, restor[e] respect for the IRS, and improve[e] voluntary compliance," specifically referencing the impact of procedural justice considerations on voluntary compliance. *Id.* at 235–36. Those suggestions included reducing the burden of complying and providing taxpayer education. *Id.* Somewhat amazingly, she felt compelled to state that the IRS should provide clear guidance on what accounts are reportable before actually requiring taxpayers to report them. *Id.* at 236. That this had to be said is unfortunate and remarkable.

States should also specifically direct communications and efforts to tax-return preparers.²⁴⁴ More than half of taxpayers use third-party preparers, who likely make the first decision of how to approach the use-tax issue—especially in those states where use tax is reported on the income-tax return.²⁴⁵ As noted above, however, data from Illinois show that people who use tax-return preparers reported use tax at a lesser rate than the general population.²⁴⁶ Targeting an educational program at those preparers, who would then presumably educate their clients, would be an efficient way of reaching many taxpayers—and perhaps a necessary step. States simply must ensure that preparers take use taxes seriously and encourage their clients to do so as well.²⁴⁷

²⁴⁴ Professor Lavoie has previously advocated for using the tax bar and accounting profession to shift cultural norms more generally. Richard Lavoie, *Flying Above the Law and Below the Radar: Instilling a Taxpaying Ethos in Those Playing by Their Own Rules*, 29 PACE L. REV. 637, 678–81 (2009) (discussing the benefit of “co-opting lawyers and other professional advisors as . . . agents of change”). Of course, those providers may be subject to the same noncompliance pressures of the clients whom they serve. Just as a contractor may feel economically compelled to “cheat” like its competitors lest it suffer a competitive disadvantage, a tax-return preparer that demands strict compliance in a culture that demands no such exaction could soon find his client list dwindling. This can be counteracted only by professional requirements imposed on those professionals. *See infra* note 247 (discussing potential professional sanctions on return prepares who fail to conduct adequate diligence on consumers’ liabilities).

²⁴⁵ *See* 2013 REPORT, *supra* note 243, at 98 (estimating that 60% of taxpayers will use tax professionals to help file returns in 2013); Patrick Langetieg et al., *Return Preparer Industry Analysis*, IRS 17, 19 tbl.1 (2013), <http://www.irs.gov/pub/irs-soi/13resconreturn-prepar.pdf>, archived at <http://perma.cc/3W5R-T88J> (reporting that, in 2013, 80.99 million of 141.7 million individual returns were prepared returns).

²⁴⁶ *See supra* note 209 and accompanying text.

²⁴⁷ States could take guidance from the federal government’s program with respect to the earned income tax credit (“EITC”). Federal law includes specific penalties for preparers who fail to exercise due diligence in determining eligibility for, or the amount of, those credits. 26 U.S.C. § 6695(g) (2013). The IRS also hosts a website informing preparers of the due diligence required and conducts audits of preparers who exhibit high levels of EITC errors. *EITC Due Diligence Law and Regulation*, EARNED INCOME TAX CREDIT & OTHER REFUNDABLE CREDITS (last updated Jan. 27, 2015), <http://www.eitc.irs.gov/Tax-Preparer-Toolkit/dd/lawandregs>, archived at <http://perma.cc/DG2Q-ECJY>; *Auditing for Due Diligence Compliance*, EARNED INCOME TAX CREDIT & OTHER REFUNDABLE CREDITS (last updated Oct. 2, 2014), <http://www.eitc.irs.gov/Tax-Preparer-Toolkit/compliance/auditing>, archived at <http://perma.cc/Q7AW-LQY8>. States could use this model to similarly focus on return-preparer processes rather than on individual taxpayers’ reporting behaviors. Although states may not implement penalties similar to the EITC due diligence penalty, targeted communications with preparers could provide some level of positive pressure on preparers’ levels of encouragement to taxpayers to pay their use taxes. At the very least, states should not ignore preparers who routinely file a high percentage of their returns reporting no use tax due.

Reaching self-filers may be more difficult, but the use of social media, traditional media, and the tax authorities' own publications could be used in an intentional way to bring about a sufficient level of knowledge of the tax. Automatic notices provided online, like the one used by Michigan, could also prove to be very helpful.²⁴⁸ States could also send notices to taxpayers who fail to report any use tax on their income-tax returns. Those notices would not rise to the level of audit letters, but would raise taxpayer awareness of the tax and could invite compliance in a manner that uses procedural-justice concepts and builds trust in government.²⁴⁹ These efforts would impose some costs on states, but providing taxpayers with a base level of knowledge of the use tax in advance of other enforcement action would be consistent with most psychological research on tax compliance. Evidence from Alabama shows that this simple approach can produce meaningful gains.²⁵⁰ The recent study in Nebraska also shows that such efforts are likely to at least pay for themselves.²⁵¹

Government education about use taxes should also make use of the potential power of social norms and normative appeals. Information regarding the equity of the tax, the uses for the funds, and the overall levels of tax compliance in the state would serve to harness or promote social norms.²⁵² Concurrently, providing information regarding the potential penalties and audit activity would remind taxpayers of their economic interest in complying. Using a variety of approaches to these communications could give researchers and states valuable insight into which types of appeals produce the best results. Given the different results from prior experiments with normative appeals,²⁵³ experimentation in this area could help to provide valuable guidance going forward.

Of course, education alone is not sufficient and, as discussed above, at least one research experiment shows that it could be detrimental.²⁵⁴ States will thus need to couple their educational reforms with other tactics. Again, the goal of these efforts is to build a norm of compliance through procedurally just methods such that aggressive actions aimed at the entire population are not needed.

B. Deterrence and Use-Tax Compliance

The research discussed above establishes the general effectiveness of the deterrence model, at least when some baseline conditions are met. First, there must

²⁴⁸ See *supra* notes 174–176 and accompanying text.

²⁴⁹ See generally Wenzel, *supra* note 97 (discussing the use of procedural-justice considerations in reminder letters to improve voluntary compliance).

²⁵⁰ See *supra* notes 190–192 and accompanying text.

²⁵¹ See Anderson, *supra* note 234, at 14.

²⁵² Naturally, any use of a descriptive norm statement must necessarily incorporate overall levels of tax compliance. Until a use-tax compliance norm is achieved, states must take great care to avoid the reality that virtually no one pays use tax.

²⁵³ See *supra* notes 73–76 and accompanying text.

²⁵⁴ See *supra* note 226 and accompanying text.

be some appreciable risk that deviants will be caught and punished. Second, because audit and penalty rates are generally too low to effectively impact the expected-utility analysis of tax evasion, withholding and information reporting are critical in motivating compliance. Unfortunately for the use tax, none of these conditions are currently met. States should remedy this situation before or concurrently with efforts to test the more modern models of tax compliance.

1. Audit Risk and Use Taxes

No amount of research can change the reality that use-tax audits are unlikely to pay for themselves on an individual basis. Taxpayer liabilities are too small and audits too costly. Research does suggest, however, that audit activity would be beneficial and could act to promote compliance in other ways that might help offset their cost.

First, states must consider the potential for an indirect audit effect. As discussed above, audits impact not only the taxpayers being audited, but others as well.²⁵⁵ Taxpayers hearing of increased (or newly initiated) use-tax audits may increase their own perception of audit risk, perhaps beyond the actual audit risk. Audit activity can thus generate revenue beyond the additional assessments generated directly by those examinations.

Audits, alone, can also act as a type of collateral sanction on noncompliance beyond the statutory penalties. No taxpayer wants to undergo the hassle of an audit, much less one that will require them to review their annual purchase data by going through stacks of credit card and bank statements. The burden of a full audit for a liability as small as a use-tax liability could thus function as an effective collateral sanction for use-tax noncompliance.²⁵⁶

Of course, any effort to increase audit risk (real or perceived) should take procedural-justice considerations into account. Directed audit activity may be detrimental to overall taxpayer beliefs about the fairness of the tax system and the trustworthiness of the tax administrator and could impact taxpayer compliance more broadly. Increasing audit rates or the perception of audit rates must therefore be done very carefully. A state may be well advised to adopt a broad, soft approach rather than an approach that appears to target an unlucky few.²⁵⁷ Thus, a system that generated an inquiry letter in response to returns reporting no use tax or use-tax liabilities falling below some expectation may be able to best harness the impact of the deterrence effect of audit activity. Taxpayers should fairly expect an inquiry if

²⁵⁵ See *supra* note 58 and accompanying text.

²⁵⁶ See generally Blank, *supra* note 4 (discussing collateral sanctions for tax noncompliance).

²⁵⁷ Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, in *WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT* 193, 214 (Joel Slemrod ed., 1992).

they report no tax due, and paying the required use tax in response would almost surely be an acceptable price to avoid the pain of an audit.

2. *Penalizing Noncompliance*

Changing the penalties owed for use-tax violations would certainly impact the general cost-benefit analysis of a taxpayer determining whether to avoid the tax. Unfortunately, however, there are likely significant hurdles to taking that action. The first is that increasing penalties would be difficult from a political perspective, especially with respect to a tax that many would consider to be new. The second problem is that penalties are generally based on the amount of evaded tax. Because use-tax liabilities are generally low, a penalty of that type is unlikely to compel compliance. Modifying the applicable penalties would thus likely require other forms of redress.

Other than the obvious suggestions of raising the penalty rates or adopting higher flat penalties for noncompliance, states could also explore more unique forms for their penalties. They could, for example, impose the penalty through an income-tax surcharge to take advantage of the salience of that tax, or they could penalize noncomplaint taxpayers by eliminating certain income-tax benefits to test whether the endowment effect would apply to those benefits.²⁵⁸ States could also test the intentional use of collateral tax sanctions (beyond the pain of audit discussed above).

As identified by Professor Blank, those sanctions generally have “three primary characteristics.”²⁵⁹ First, “they rescind or deny a government benefit or privilege. . . .”²⁶⁰ Second, “they are enforced by an agency other than the taxing authority. . . .”²⁶¹ Finally, “they apply in addition to the formal tax penalty. . . .”²⁶² Examples include denial or revocation of a passport, deportation, denial of housing assistance, and the revocation of licenses like driver, professional, liquor, or recreational licenses.²⁶³ Professor Blank identified a number of reasons that such sanctions may be more effective than monetary penalties based on the existing models of tax compliance,²⁶⁴ and he proposed some “guiding principles” for governments seeking to implement such sanctions effectively.²⁶⁵ Those sanctions, for example, may be more

²⁵⁸ See *supra* note 132 and accompanying text (providing information about the endowment effect).

²⁵⁹ Blank, *supra* note 4, at 735.

²⁶⁰ *Id.*

²⁶¹ *Id.*

²⁶² *Id.*

²⁶³ *Id.* at 736–44.

²⁶⁴ *Id.* at 749–68. Those include the fact that such penalties may be more salient to taxpayers, they may take advantage of various cognitive biases, they may impose greater economic costs, they may emit negative reputational signals, they improve feelings of reciprocity and retributive justice, and they reinforce tax compliance as one of the duties of being a citizen. *Id.*

²⁶⁵ *Id.* at 774–80

appropriate where the tax offense relates to a clear, specific obligation rather than a looser standard,²⁶⁶ should be imposed only when the taxing authority defines and identifies a violation of the tax law,²⁶⁷ and should be proportionate in magnitude to the tax offense.²⁶⁸

Under this structure, collateral consequences for use-tax noncompliance could be properly considered by states. First, the requirement to pay use taxes is a clear rule.²⁶⁹ Second, the taxing authority could certainly take responsibility for defining and identifying violations. The easiest method under current practice would be to simply note when a taxpayer reports absolutely no use tax due and trigger the sanction until the taxpayer reports some good faith amount or establishes the fact of no liability. The most difficult aspect of that approach would be to find a collateral sanction that is proportionate to the failure to pay use tax. The loss of a driver or professional license is likely too large of a penalty for an unpaid tax that probably would amount to less than \$200. States could, however, make renewal of those licenses less pleasant for those who do not comply. Requiring an in-person application or renewal process in lieu of a computer-based process, for example, may impose a significant enough cost that individuals may prefer to report their use taxes. States could undoubtedly find other public conveniences that could be provided only to those who care to share in the cost. What is important is that they can think beyond traditional monetary penalties when evaluating how to improve use-tax compliance.

3. *Addressing the Costs of Complying*

Increasing the costs of noncompliance might very well help to induce some taxpayers to pay use taxes, but, as a practical matter, states may be unwilling to increase audit activity or penalties. The former would require a significant expenditure of resources, and the latter would require legislative action, which may be difficult to obtain. It may be more likely then, that states could address taxpayers' cost-benefit analyses by addressing the costs of compliance rather than the costs of noncompliance.²⁷⁰ Regardless of how people feel about tax obligations, they will not

²⁶⁶ *Id.* at 774.

²⁶⁷ *Id.* at 776–77.

²⁶⁸ *Id.* at 777–80.

²⁶⁹ *Id.* at 783 (noting that “[t]he requirement to file a tax return is an explicit tax rule, not a tax standard”).

²⁷⁰ Reducing compliance costs may not only be a more pragmatic approach, but it might also be essential in developing a social norm of compliance. Research on social norms in the context of recycling has shown that the effectiveness of social norms is significantly impacted by the amount of effort required of an individual. *See* Ann E. Carlson, *Recycling Norms*, 89 CALIF. L. REV. 1231, 1276–80, 1295–96 (2001) (discussing the impact of structural changes that made participation in recycling programs more convenient and concluding that such efforts were both “more effective than most persuasive techniques aimed at increasing participation” and “result[ed] in sustained behavioral change”). Indeed, Professor Carlson

comply if it is too burdensome given the amounts of tax at issue. The benefit of complying can simply be overwhelmed by the costs of doing so.

This is a legitimate concern with respect to use taxes. Paying those taxes requires people to track their annual purchase activity and to determine (1) which of their purchases had no tax collected at the point of sale, (2) whether any of the purchases were tax exempt, and (3) the amount of tax that is owed. All but the final task could be quite difficult. Why would anyone suffer through those tasks to pay a tax that is likely relatively small and that will not be enforced? States cannot ignore this reality. They must work to change the costs of compliance or at least the perception of those costs if they want to induce taxpayer compliance.

Fortunately for states, compliance may not be nearly as costly as many consumers assume. The most significant online retailer in the United States, Amazon.com, allows consumers to view their annual purchases with relative ease within their account information.²⁷¹ If consumers just compiled that data, they could likely determine a significant percentage of their taxable purchases in less than an hour. Of course, a variation of the Pareto principle probably applies. Consumers will likely be able to find 80% of their online purchases with 20% of the work that it would require them to find 100% of their purchases. For states, 80% would be significant—perhaps even acceptable.

States could also work to change the actual costs of complying, for example, by allowing taxpayers to report use tax based on tables or reducing the types of transactions subject to the use tax.²⁷² One could also imagine an enterprising state or consortium of states developing an in-browser app that would allow consumers to track and aggregate their use-tax data while they are making online purchases.

concluded that strengthening social norms may be fruitless unless government can make compliance simpler. *Id.* at 1299. Use-tax payments and recycling arguably share many characteristics as large-number, small-scale collective action problems, but recycling programs benefit from widespread public support that additional taxation does not. States may thus benefit less from reducing the costs of compliance with respect to use taxes than has been seen with respect to recycling programs. *See id.* at 1281–82 (noting that “caution seems due in extrapolating” the conclusions from analysis of recycling data to “problems whose resolution lacks similar widespread support”). Of course, states could also attempt to change the existing aversion to additional taxation by educating taxpayers on the broad benefits that could be derived from wide-spread use-tax compliance, whether in the form of increased funding for items of need, deficit reductions, or funds available for tax cuts in other areas.

²⁷¹ Users are able to view their purchases from that retailer within their account information. That information can be viewed by calendar year. *See Your Orders*, AMAZON, www.amazon.com (last visited June 27, 2015) (a user must log in and click on the “Your Account,” then the “Your Orders” button to view this option).

²⁷² *See Thimmesch, supra* note 141, at 42–46 (discussing how states could modify their use-tax systems to make compliance simpler for taxpayers). As noted above, average participation is significantly increased when tables are provided to taxpayers. *See supra* note 180 and accompanying text.

Pursuing that type of option would be novel and costly, but the potential tax-revenue gains may justify the investment given the revenue estimates that states are touting.

A more aggressive method of reducing the costs of compliance and promoting compliance under the deterrence model would be to implement an information-reporting system like that adopted by Colorado.²⁷³ As discussed above, much of our system of tax compliance works because of the intervention of third parties. That traditionally takes the form of withholding at the source and information reporting to the taxing authority. States have thus far focused their efforts on the former, and the Marketplace Fairness Act would certainly make great strides on that point. However, states could put more energy into the latter—information reporting.

The materials above discussed a number of states that have attempted some form of information reporting, and the most extensive of those requirements—imposed by Colorado—is currently subject to legal proceedings to determine its constitutionality.²⁷⁴ That challenge is based on concerns regarding state power under the Dormant Commerce Clause and concerns regarding taxpayer privacy.²⁷⁵ Each of those concerns can likely be addressed within a system that still promotes voluntary compliance.

First, the issues regarding states' powers to compel out-of-state vendors to provide information reports are largely based upon *Quill* and the effect of the physical-presence rule. As the *Quill* court made clear, however, Congress can override that rule through affirmative action under its Commerce Clause power.²⁷⁶ Thus, instead of waiting for litigation to bless such statutes, one option for states would be to lobby Congress for the power to require vendors to provide information reports to their customers. That approach may prove to be a good compromise between states and retailers. Neither group would prefer this approach, but it might be a good second-best solution.²⁷⁷ States would prefer that approach to nothing, and merchants would likely prefer it to the passage of the Marketplace Fairness Act. Remote vendors would still face the difficulty and costs of providing the notices, but they would not be subject to the intrusive and costly audits that come as a part of being a tax collector.

To address the privacy concerns inherent in an information-reporting system, Congress could allow states to require vendors to provide information reports to consumers, but prevent states from requiring that their tax authorities receive a copy as well. The level of detail that those reports contain can be troubling. This is true

²⁷³ See *supra* notes 181–185 and accompanying text.

²⁷⁴ See *supra* note 186 and accompanying text.

²⁷⁵ John Buhl, *DMA Sues Colorado Over 'Amazon Law'*, 57 ST. TAX NOTES, July 2010, at 12. See also Gaylord & Haile, *supra* note 142, at 2039–60, 2084–91 (analyzing the First Amendment concerns with vendor disclosure to states).

²⁷⁶ See *supra* note 13.

²⁷⁷ Of course, one cannot ignore the practical difficulties of getting Congress to act in such a way, or at all. Hopefully, however, action would be more likely if states and retailers approached Congress with a resolution that was acceptable to both.

even if individual purchase data is removed.²⁷⁸ Individual expression may be chilled simply by the government knowing that taxpayers shop with certain retailers—perhaps those specializing in controversial political, religious, or sexual products.²⁷⁹ A more restrained information-reporting requirement would avoid those concerns.

Some might understandably be worried that an information report provided only to consumers would be ineffective and reject this suggestion on that ground. One could easily surmise that information reports are of benefit precisely because they provide government with the information necessary to determine a tax liability. Fortunately, recent research suggests that much of the benefit of information reporting could be obtained without requiring vendors to send consumer information to the state. For example, the research on compliance with the VAT in Chile suggested that the mere presence of a paper trail induces compliance, even if the government is not automatically provided a copy of the documents that make up that trail.²⁸⁰

Finally, it should be noted that this type of federal approach might be preferable to the Marketplace Fairness Act because it would make the use tax more salient to taxpayers and impress upon them the extent of their obligations to pay. That approach would thus promote compliance with respect to *all* taxable items, rather than just capture revenue from purchases made from retailers subject to the Marketplace Fairness Act.

C. Increasing Compliance Through Appeals to Nonpecuniary Interests

The efforts discussed above would respond to the traditional economic model for tax compliance, and those efforts would seem highly advisable given the large predictive power of that model. Of course, states are undertaking some of those steps already. Many states are undertaking publicity efforts.²⁸¹ They are also making it easier to pay that tax, some by putting a use-tax line on their income-tax returns and some by providing charts to show average amounts owed.²⁸² As a first step, states and researchers should expand those efforts and also evaluate the existing compliance data more closely to determine the different reporting rates among states. Existing data show that certain states have been able to generate much higher levels of compliance than others.²⁸³ Isolating the factors that have caused that difference could provide significant information to states, researchers, and the federal government.

Ultimately, though, the same basic structural flaw that haunts use taxes today may prevent the extension of existing efforts from increasing compliance—each

²⁷⁸ See Gaylord & Haile, *supra* note 142, at 2084–91.

²⁷⁹ *Id.* at 2085.

²⁸⁰ See *supra* notes 52–57 and accompanying text.

²⁸¹ See *supra* Section III.B.

²⁸² *Id.*

²⁸³ See *supra* notes 147–155 and accompanying text.

individual consumer simply does not have enough tax at issue to make state enforcement efforts seem credible. The success of state efforts in that area will thus depend on gaining that credibility, which may mean more enforcement dollars spent than taxes collected in the short term. For these reasons, significant attention should also be given to the nonpecuniary models of compliance discussed above. A few suggestions are offered below.²⁸⁴ These include (1) providing taxpayer voice in the use-tax context, and (2) applying behavioral theories to the use tax.

1. Taxpayer Voice

One of the most intriguing opportunities for states to apply current tax-compliance research appears to be with respect to the value of voice in tax compliance. Giving taxpayers a voice, in the form of gathering taxpayer opinions on matters related to taxation and budgeting, has been found to increase feelings of procedural justice and to increase tax compliance in many experiments.²⁸⁵ That line of research thus presents an intriguing opportunity, and states could introduce voice into the use-tax system in many ways. Two particular options are discussed below. First, states could provide taxpayers with an opportunity to express a preference as to the use of their use-tax payments. Second, states could invite taxpayers to simply provide their opinions of the tax when they file their returns.

The idea of voting on the allocation of tax payments is not new. As discussed above, researchers have experimented with this in laboratory settings for years.²⁸⁶ Professor Dan Ariely, a leading behavioral economist, has suggested this approach.²⁸⁷ Allowing taxpayers to vote on the use of their taxes provides them a voice and a sense of agency in the process. This may be a way to increase use-tax compliance without engaging in costly deterrence efforts. Of course, the mechanics of implementing such a system will necessarily vary by jurisdiction, but there are likely to be some uniform political and economic concerns.

As an initial matter, allowing taxpayers to determine how their use-tax payments will be spent would seem to introduce unacceptable uncertainty into states' budgeting processes. States would not know how their programs would be funded, which would impede the proper functioning of state government. Budget cycles and efficiency considerations could thus be reasons to reject consideration of such an approach. These concerns are appropriate, but not insurmountable. First,

²⁸⁴ Of course, it is important to note that many of the suggestions previously offered incorporate, or could incorporate, these appeals to nonpecuniary interests. Information campaigns can take advantage of the bulk of literature on the impact of normative appeals in information letters. Deterrence efforts should also take procedural-justice considerations into account.

²⁸⁵ See *supra* notes 104–112 and accompanying text.

²⁸⁶ See *supra* notes 108–112 and accompanying text.

²⁸⁷ Dan Ariely, *Celebrating April 15th (17th)*, DAN ARIELY BLOG (April 17, 2012), <http://danariely.com/2012/04/17/celebrating-april-15th/>, archived at <http://perma.cc/D9XQ-8G3X>.

because taxpayer voice may have noninstrumental value and because the eliciting of taxpayer comment may create a “false consciousness of control,”²⁸⁸ states need not necessarily allow taxpayers to make *binding* allocations of their use-tax payments. States could thus experiment with allowing taxpayers to express a preference on how their use-tax payments are used without giving up any actual control.²⁸⁹

State concerns about allowing voice through voting would also appear to be unwarranted even if taxpayer allocations were binding. Given that use-tax compliance is currently virtually nonexistent, any use-tax funds received due to the provision of voice through binding tax allocations would be new revenue. States currently do not rely on those funds so any administrative or planning issues would come from a surplus of funds. That is hardly a reason to avoid raising the funds in the first place.²⁹⁰ Further, to the extent that states do currently receive some use-tax revenue or start to receive that revenue after successful attempts to increase compliance, they could make clear that the allocations would apply only to a portion of the funds collected or perhaps to the increased revenue collected, either on an individual or aggregate level.²⁹¹ Recall that research has shown diminishing returns from tax allocations over a certain percentage of the amount owed.²⁹² States could also potentially discontinue the practice if a strong enough norm of compliance develops.²⁹³ Of course, it hardly needs to be mentioned that dollars are fungible. As long as the state does not allow citizens to allocate their funds to a new project, the money that is allocated under this system could simply offset funding that could be directed elsewhere.²⁹⁴

²⁸⁸ Lind et al., *supra* note 106, at 958.

²⁸⁹ States, however, should pay attention to the possibility of a “frustration effect” if taxpayer allocations are simply ignored. *See id.* at 953 (“There is evidence that, under some circumstances, people actively reject procedures that appear to offer process control but that do not provide any real input into the decision-making process.”).

²⁹⁰ The corollary of this recognition is that experimenting with use-tax compliance is relatively risk-free. There is simply little revenue to be lost from attempting a method that is unsuccessful.

²⁹¹ In this regard, it is important to remember that we are simply trying to create a norm of compliance. Once that norm is established, states should be able to rely more on the norm and less on the other methods of increasing compliance. *See Lavoie, supra* note 244, at 674–76; Leigh Osofsky, *Concentrated Enforcement*, 16 FLA. TAX REV. 325, 354–55, 371–72 (2014) (noting the variety of scholarship on norm tipping points and their application to tax compliance). The impacts of lessened allocation power would thus be mitigated by the development of a compliance norm.

²⁹² *See supra* note 111 and accompanying text.

²⁹³ *See* Jon S. Davis et al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 ACCT. REV. 39, 61–63 (2003) (reporting results that suggest that changes in enforcement mechanisms may change behavior among noncompliant individuals, but that eliminating enforcement will not cause compliant populations to shift to noncompliant).

²⁹⁴ Of course, the psychological impact of this accounting practice should be considered and monitored.

Providing voice through tax allocations would also potentially provide more political cover for those politicians who would otherwise resist use-tax compliance efforts due to the political pressure against “new” taxes. Recent scholarship has focused on the impact of earmarked taxes, under which states raise new taxes in order to fund specific projects.²⁹⁵ Using a public-choice-theory approach, Professor Susannah Camic Tahk has analyzed the relative success of states in raising revenue using such taxes.²⁹⁶

Professor Tahk’s analysis specifically points to the positive impact that concentrated benefits have on the likelihood that a tax will be passed or retained, especially when the costs of that tax are diffuse.²⁹⁷ Naturally, with targeted benefits, a tax has a natural pool of advocates, and, with diffuse costs, potentially no detractors with enough interest in fighting the tax. To be sure, this is a different set of factors than may be involved when discussing how to increase compliance with an existing tax, and Professor Tahk’s observations may not directly support allowing taxpayers to allocate their use-tax payments. However, the state experience with earmarked taxes does show the benefit of finding public support for new taxing measures through the dedication of funds to a particular, popular project or cause. Paying taxes to support such a cause is more palatable than simply paying more to a general fund. Allowing use-tax filers to allocate their payments would do just that. If states have found that citizens are more willing to enact or retain tax provisions when the benefits to them are more clear or targeted, it is not irrational to assume that individuals would similarly “vote” in favor of the use tax by making a payment that is directed to their personally preferred use.

In all, it appears as though states have every reason to experiment with seeking taxpayer preferences as to the allocation of their use-tax payments. There is little revenue at risk if the efforts somehow backfire; states have latitude in whether and to what extent to make those allocations binding, and those allocations may make the use tax more politically acceptable.

Another way that states could provide taxpayers with a voice is by simply inviting comment as part of the tax-filing process. States could affirmatively ask taxpayers to comment on the use tax in connection with their annual tax return. Although such an approach would clearly give a post-decision voice, noninstrumental theories of voice suggest that this approach may increase

²⁹⁵ Susannah Camic Tahk, *Making Impossible Tax Reform Possible*, 81 *FORDHAM L. REV.* 2683, 2686 (2013) [hereinafter Tahk, *Making Impossible Tax Reform Possible*]; Susannah Camic Tahk, *Public Choice Theory & Earmarked Taxes*, *N.Y.U. TAX L. REV.* (forthcoming 2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2311372, archived at <http://perma.cc/6KDR-FRUQ> [hereinafter Tahk, *Public Choice Theory*]. For purposes of this line of scholarship, the term “earmarked” refers only to taxes where the use of the funds is specifically directed at a particular use or recipient. Tahk, *Making Impossible Tax Reform Possible*, *supra*, at 2686 n.14; Tahk, *Public Choice Theory*, *supra*, at 2.

²⁹⁶ See generally Tahk, *Public Choice Theory*, *supra* note 295, at 2.

²⁹⁷ See *id.* at 8 (noting that such laws are “relatively easy to enact” and “relatively easy to maintain and to extend”).

compliance. This avenue may be especially important in an era where the public feels significantly less satisfied with government. Perhaps providing an outlet for taxpayer frustration would increase perceptions of procedural justice and increase compliance in that way.

This approach, like others, comes with little risk of reducing use-tax revenues because current compliance rates are so low. However, it is worth considering whether giving taxpayers an opportunity to “vent” on their return would cause them to overweight their negative views of the state taxing authority at the time of their return filing. This could manifest itself in more aggressive filing positions. It might therefore be advisable, and informative, for states to experiment with respect to the structure of the call for comment. For instance, it could be coupled with a statement reminding taxpayers of the services that they receive or a normative appeal, or it could be detached from the income-tax filing all together.

2. Behavioral Use Tax

No modern discussion of potential avenues for increasing tax compliance would be complete without a discussion of potential application of the behavioral sciences. A few options that may apply well in the use-tax context are discussed below.

(a) Withholding

The use of withholding as a method of increasing compliance is not new. Withholding has been offered as a method to take advantage of taxpayers’ general aversion to risk taking with respect to gains. As noted above, scholars have thus offered “advance payments” as a potential solution to income-tax underreporting for purposes of nonwage income for years.²⁹⁸ These theories rest on the idea that once tax is withheld, taxpayers are put into a gain position if they seek a refund of those amounts. They are thus less likely to take a risky position. This is in contrast to the loss position into which they are put if they are required to voluntarily report and pay tax on their income at the end of the year.²⁹⁹

This concept could be applied to use taxes with relative ease for states. States already withhold for wage income. They could thus either allocate a portion of the already withheld amounts to use taxes, or they could adjust their withholding tables to include an amount of use tax. States with use-tax lookup tables already make some estimation of use-tax liabilities by reference to taxpayers’ incomes, so this process

²⁹⁸ See *supra* notes 125–127 and accompanying text.

²⁹⁹ Of course, these proposals rely on this framing effect holding true for taxpayers. Consideration of the procedural-justice implications of purposeful over withholding is also required. These issues are thus worth further study.

would not be entirely new.³⁰⁰ The biggest challenge to the implementation of this approach would appear to be the cost of modifying states' information-reporting systems to accommodate and reflect the allocation of part of the withheld amounts to use taxes. The potential benefits, though, appear significant.

(b) Other Behavioral Approaches

The application of behavioral approaches to use-tax compliance could take myriad forms. One could imagine a state imposing default use-tax liabilities out of which taxpayers must affirmatively opt,³⁰¹ strategically placing a jurat on the tax return, or providing an immediate credit for reported use-tax liabilities along with a delayed repayment date to take advantage of taxpayer hyperbolic discounting. What is clear is that there are a number of ways in which identified decision-making biases could be used to help increase use-tax compliance.

One particularly interesting way in which states and researchers could experiment with “choice architecture” in the use-tax context would be to collect and analyze data with respect to, or experiment with, the use-tax line item that states have placed on their income-tax returns. As discussed above, states have implemented that line item in a number of ways. Some simply have a line for reporting tax due, some require taxpayers to affirmatively write the word “zero” on their return if they are reporting no tax due, while others require taxpayers to simply indicate that they have no liability.³⁰² Though compliance rates in those states are still very low, it may nonetheless be interesting to analyze whether those different forms have resulted in meaningfully different levels of compliance. Beyond evaluating existing data, one could imagine states and researchers “nudging” consumers in different ways through the use of different design choices with respect to the use-tax line item or the use of a use-tax schedule.³⁰³ States could also test variations of the lookup tables that some provide to taxpayers. Research could evaluate whether consumers will always anchor to the number provided in such a table or if states could nudge them to look beyond that number instead. States already

³⁰⁰ This approach would necessarily fail to reach those who do not earn wages as employees, which may introduce some equity concerns. This should not necessarily counsel toward ignoring the potential benefit of withholding, but suggests more careful study and analysis into the interactions of the different variables impacting voluntary compliance. A state looking into an advance-payment approach for independent contractors could also incorporate use-tax payments into that scheme.

³⁰¹ The impact of default rules is well established in the behavioral-sciences literature. See Cass R. Sunstein, *Empirically Informed Regulation*, 78 U. CHI. L. REV. 1349, 1350–51 (2011) (discussing the impacts of default rules).

³⁰² Manzi, *supra* note 147, at 7–8.

³⁰³ For example, requiring taxpayers to affirmatively attest that they do not owe any use tax, or to check a box to that effect, would presumably be more effective than allowing taxpayers to simply put a “zero” in the reporting box.

use a variety of methods for their use-tax lines on their income-tax returns and their lookup tables, but they could do so in a more intentional manner.

States and researchers could also experiment with using collateral tax consequences as a way to harness and evaluate the impact of cognitive biases on tax compliance. As discussed above, states can increase the costs of noncompliance by imposing sanctions that go beyond simple monetary fines. They could also do so in ways that take into account, and experiment with, the impacts of loss aversion and the endowment effect.³⁰⁴ For example, states could deny income-tax benefits to those who improperly fail to report and pay use taxes. This could test whether the loss of an income-tax benefit would create the same psychological impact as the loss of another governmental benefit, or whether it would have the same impact as a monetary fine. The use of collateral tax consequences was discussed above, but they must be mentioned with any analysis of the potential power of behavioral economics on use-tax compliance.

Ultimately, there is significant interest in the application of the behavioral sciences into new areas of regulation. State use taxes present many opportunities to test the real-world impacts of common behavioral theories.

V. BEYOND USE TAXES

A. *Opportunities*

The discussion in this Article is directly aimed at use-tax compliance, but it would be much too shortsighted to ignore the broader impacts that efforts in this area could have. The materials above demonstrate that researchers have identified many factors that contribute to tax-compliance decisions, but also that there are many areas of uncertainty. Not the least of those uncertainties is how the various factors interact for different populations of taxpayers. There are also uncertainties regarding the effectiveness of normative appeals, the noninstrumental value of procedurally just practices, and how taxpayers frame tax decisions for purposes of behavioral analyses. Application of the models of tax compliance to state use taxes would thus serve not only to increase use-tax compliance, but could provide incredibly valuable information regarding the validity and application of those methods in a real-world setting. This is of critical importance. Indeed, researchers recognize the limitations of laboratory experiments and the benefit of, and need for, field experiments to further our knowledge of the motivators of tax compliance.³⁰⁵

³⁰⁴ See Blank, *supra* note 4, at 752–55.

³⁰⁵ Alm, *supra* note 24, at 75 (2012); Hallsworth et al., *supra* note 73, at 27; Luttmer & Singhal, *supra* note 62, at 166; Michael Pickhardt & Aloys Prinz, *Behavioral Dynamics of Tax Evasion—A Survey*, 40 J. ECON. PSYCHOL. 1, 14 (2014); Benno Torgler, *Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments*, 16 J. ECON. SURVS. 657, 661 (2002).

State use taxes present a very real opportunity for that type of research, and the benefits would extend far beyond states and their budgets. Application of the models of tax compliance would not only help states to close their use-tax gaps, but the lessons learned could help researchers to further understand the models of tax compliance more generally. Researchers and states should thus work together to run controlled experiments on these models of compliance specifically in the use-tax context. Through those joint efforts, researchers can learn more about those models and perhaps apply those lessons to the federal tax gap and tax gaps worldwide.

Although it is beyond the scope of this piece to completely outline a research framework, it is important to more fully explain why the use-tax gap is a beneficial area to research. The relevance of this little-known state tax to federal income taxes may not be self-evident, especially to those who usually focus on national-level taxes.

As an initial matter, experimentation in the use-tax area should be attractive because there is little risk of causing any loss.³⁰⁶ Given the lack of any meaningful use-tax compliance currently, state revenue authorities need not be significantly concerned that any particular attempt might “backfire” and cause a loss of revenue. The lack of current collections may also give states more flexibility in how to frame their efforts. As noted above, one potential experiment would be to allow taxpayers to make binding allocations of their tax payments. States wanting to experiment with that method for encouraging compliance may find that easier to do in the context of a tax where all of the revenue collected would be new. Thus, the fact that any use-tax revenues would be a new category of revenue for a state may mean that states have more flexibility to experiment.

The lack of current compliance and the lack of current compliance *efforts* may also make it easier to isolate the effects of any particular experiment. An experiment applying a particular treatment to taxpayers with respect to their use-tax liabilities taxes would produce results with fewer complicating factors than an experiment involving federal income-tax obligations. Research on federal income-tax compliance is complicated by more significant outside influences (e.g., general awareness and politicization of the income tax, general public discussion regarding the fairness of the federal tax system, election-related attention to tax compliance or tax reform, etc.). An otherwise ignored tax may reduce that noise. Of course, the lack of current collections could also be a negative for researchers. It would be more difficult to determine if a particular action would serve to reduce compliance, though it seems unlikely that a state would permit a field experiment with a meaningful risk of lost revenue in any event.

Use-tax experimentation would also benefit from the fact that there are forty-five different states that impose a use tax.³⁰⁷ The role of states as laboratories for

³⁰⁶ Cf. *supra* notes 43–54 and accompanying text (discussing a Minnesota study that decreased income-tax compliance among high-income taxpayers).

³⁰⁷ Shelia O’Sullivan et al., *State Government Tax Collections Summary Report: 2013*, U.S. CENSUS BUREAU 6 (Apr. 8, 2014), <http://www2.census.gov/govs/statetax/2013stc>

testing different legal and social structures is well engrained in the U.S. political and legal system.³⁰⁸ Tax-compliance researchers could use that political laboratory for use as an actual laboratory. To the extent that states have different characteristics or that experimental efforts can be coordinated, research on state use taxes provides an excellent laboratory to test the models of compliance. Differences in current use-tax compliance rates already offer an interesting avenue for such research. Experimentation would simply further leverage the benefit of our federal system.

Within the laboratory of the states, use taxes also present a particularly beneficial type of tax with which to experiment. This goes beyond the mere lack of current compliance discussed above. Rather, use taxes have the benefit of being relatively isolated in their application and impact. This is in contrast to state income taxes, which both rely upon and have an impact on individuals' federal income taxes.

State income-tax calculations rely on a person's federal income taxes because those calculations generally begin with a taxpayer's federal taxable income.³⁰⁹ A number of adjustments are then made to that amount to take into account local desires and conditions. To prevent abuse, state revenue authorities and the federal government share taxpayer information. A taxpayer who feels compelled by some experimental method to report more income to her state is therefore effectively prevented from reporting that income *only* to her state. Any attempt to increase compliance with state income taxes therefore must not only be effective at the state level, but it also must overcome any taxpayer aversion to paying more federal income taxes. That factor may mitigate or overwhelm the positive impact of attempts at the state level.

State income-tax calculations also impact a person's federal income taxes because once a state tax liability is paid, taxpayers who itemize their deductions are allowed a deduction for those amounts against their adjusted gross income.³¹⁰ Income-tax reporting positions thus implicate both state and federal interests. The two taxes are inextricably intertwined.

State use taxes are not so entangled. A persons' use-tax liability is generally not tied to their income-tax liability. With limited exceptions, use taxes are neither determined by reference to income-tax amounts nor do they impact those amounts.³¹¹ The isolated nature of the use tax thus removes another complicating factor in determining the impact of a compliance effort.

report.pdf, archived at <http://perma.cc/P8UM-2BH2>.

³⁰⁸ See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

³⁰⁹ See *supra* note 10 and accompanying text.

³¹⁰ 26 U.S.C. § 164(a)(3) (2012).

³¹¹ This is, of course, not true in states where taxpayers can report their use-tax liabilities by making reference to a table that makes use of their taxable income calculations, or for individuals who deduct their state sales and use taxes, rather than state income taxes, from

It is also interesting to note that the conditions impacting state use-tax compliance are similar to the conditions that will test tax compliance globally with respect to emerging areas like cryptocurrency transactions and the so-called sharing economy. IRS data show that compliance suffers dramatically when information reporting and withholding at the source are not available or are not required.³¹² Generating compliance is even harder when the information required for a revenue authority to establish a liability is decentralized. Those conditions are equally present with respect to use taxes and income taxes on transactions in the new economy.

Use taxes are difficult to enforce, in part, because states currently have little way of efficiently knowing consumers' purchasing behavior and thus rely on taxpayer self-disclosure. Further, there is little centralization of information because consumers shop from a multitude of retailers. Cryptocurrency transactions and nonwage income sources are similar in that they may involve diffuse parties that likely hold only a sliver of the information needed by the taxing authority. Absent information reports, the revenue authority must rely on the goodwill of the taxpayer to collect revenue from those transactions. As more of the economy moves into these areas, compliance research will become more important. Research on use-tax compliance could help to provide valuable information on the motivators of compliance in these situations.

B. Weaknesses

The preceding analysis is not meant to suggest that experimentation in the use-tax arena would provide us with perfect results directly applicable to tax gaps of all types. To begin with, use taxes and federal income taxes bring with them much different baggage. To the extent that compliance with a tax depends on factors like the public's perception of the utility of the tax or the legitimacy of the government imposing the tax, results from use-tax experimentation may fail to translate into the federal income-tax system. Additionally, moving compliance from near zero to something greater may involve much different factors than what is needed to improve compliance when most already voluntarily comply. Results from use-tax experimentation may therefore fail to provide any new information regarding how to close the federal income-tax gap.

There is no use in ignoring these difficulties, but they should not prevent states and researchers from undertaking use-tax experimentation. If they can obtain use-tax compliance due to factors that do not currently exist with respect to the federal income tax (perhaps taxpayers' personal feelings of attachment to their local government, for example), then researchers and the federal government will have more information regarding ways in which to change the federal income tax or the

their federal income. *See* 26 U.S.C. § 164(b)(5) (2012) (allowing taxpayers the option of deducting their state and local sales taxes in lieu of their state and local income taxes).

³¹² *See supra* note 38.

structure under which it is imposed. They could also better understand the impediments to tax compliance. If the factors that drive use-tax compliance are not replicable under the federal tax system, then researchers will know that they must be more creative in promoting compliance. Finally, even though use taxes may be different than income taxes as a qualitative matter, they should not function as worse proxies than lab experiments where exactions are simply labeled a “tax.” Existing laboratory research on tax compliance depends on artificial constructs that attempt to replicate real-world behavior by simply labeling expenditures as taxes or by asking people to make decisions about hypothetical scenarios.³¹³ The results from those experiments can predict taxpayer behavior regardless of their lack of direct fit. Use-tax experimentation is unlikely to be a worse proxy than those laboratory experiments.

It would also be short-sighted to reject use-tax experimentation simply because the current compliance norm is so different than for federal income taxes. Building compliance from a 0% rate to a 20% rate is certainly different than building compliance from an 80% rate to a 100% rate. The factors motivating those changes and the classes of taxpayers making those changes in behavior may be very different. The “early adopters” may do so simply because they become aware of the tax or because they are very risk averse. Informational returns or weak threats of audit may work on those individuals, but fail to cause greater compliance among those who have chosen to ignore their income-tax obligations. Again, however, this does not mean that use-tax experimentation would be fruitless.

First, understanding how and why taxpayers comply when compliance is otherwise low may be helpful in understanding how to maintain a compliance norm. Second, compliance with income taxes is not high for all types of taxpayers and for all types of income. As noted above, compliance levels differ among populations

³¹³ See Alm, *supra* note 24, at 66 (2012). Professor Alm describes laboratory research on tax compliance as follows:

The basic design of most compliance experiments is similar. Human subjects in a controlled laboratory are told that they should feel free to make as much income as possible. At the beginning of each round of the experiment, each subject is given (or earns) income and must decide how much income to report. Taxes are paid at some rate on all reported, but not on underreported, income. However, underreporting is discovered with some probability, and an audited subject must then pay a fine on unpaid taxes. This process is repeated for a given number of rounds. At the completion of the experiment, each subject is paid an amount that depends on his or her performance during the experiment. Into this microeconomic system, various policy changes can be introduced, such as changes in audit probabilities or audit rules, in penalty rates, in tax rates, in public good provision, and in any other relevant institutions.

Id. Of course, he also recognizes that “there are legitimate concerns about the ‘external validity’ of experimental studies of tax compliance.” *Id.* at 67.

and with respect to certain income sources. Creating some compliance from no compliance may thus be more applicable to those situations—precisely the situations that need significant improvement. Third, as noted above, building compliance with respect to use taxes may serve as a good proxy for building compliance with respect to taxes on income in the new economy or in countries without norms of compliance. Instead of attempting to divine which factors have created compliance norms in the past, research in the use-tax area could be used to look at building a compliance norm in “real time.” If states can create compliance norms with respect to use taxes using modern theories of tax compliance, the lessons from those actions would be of great utility.

As a final matter, it may very well be that states and researchers are still unconvinced that these efforts are worthwhile because, at a base level, taxpayers simply have no meaningful economic incentive to pay use taxes and doing so would place them in the vast minority of taxpayers. Certainly, the limited experimentation that has been done to date has provided little reason to be optimistic about future efforts. Without any risk of detection and penalty, why would anyone comply?

It would be foolish to ignore the great impediments to obtaining a meaningful level of voluntary compliance with state use taxes given the current economics for individual taxpayers and for states. However, if one truly believes that compliance depends on something more than deterrence theory, use-tax experimentation will be highly valuable. Given the lack of any real deterrence in this area, any compliance that can be generated absolutely must be attributable to the validity of those alternative models. Likewise, if no compliance can be obtained, researchers can acknowledge the primacy of the classic deterrence model—at least as a first step—in obtaining a compliance norm.

In the end, use-tax experimentation will not provide data and results that are perfectly applicable to the federal income-tax gap. However, that does not mean that experimentation is not warranted. The data would be valuable in many ways, both to tax researchers and administrators in the United States and to those abroad.

VI. CONCLUSION

Tax-compliance issues continue to afflict governments worldwide. A number of models of tax compliance have developed to help explain taxpayer behavior, but significant questions persist. As this Article has explained, experimentation has produced conflicting results within particular models of compliance, and the interaction between the various predictive factors is uncertain and complex. Further research is thus needed, and this Article argues that research and attention would properly be directed to promoting individual compliance with state use taxes. Compliance with those taxes is virtually nonexistent, and states’ efforts to require vendors to collect those taxes have been unsuccessful. Further, even if states obtain authority to require vendors to collect those taxes, it appears as though less than one-half of the use-tax gap would be closed. This presents a remarkable opportunity for states and researchers to apply the models of tax compliance. The benefits of testing those models in the use-tax context would inure to states in the form of increased

revenue and to researchers and governments worldwide in the form of additional information on how tax-compliance models work more generally. It is thus time to stop assuming that state use taxes are unenforceable and time to use the great opportunities presented by those taxes.