

# POLICY ESSAY

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## SERIOUS TAX FRAUD AND NONCOMPLIANCE

### Fairness matters—more than deterrence Class bias and the limits of deterrence

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The recent financial crisis aggravated problems with an already troublingly high national debt because government has both bailed out reckless financial institutions and spent money to stimulate an economy wrecked by the “wilding” of financial institutions. Thus, the context for “Serious tax fraud and noncompliance” (Levi, 2010, this issue) is strategizing about how to reduce the “tax gap”—the difference between what is owed to the government under existing tax laws and what is collected (General Accounting Office [GAO], 2008a; Her Majesty’s Revenue and Customs [HMRC], 2009, 2010). In the absence of literature on high-end tax evasion specifically, Levi examines general findings about the impact of increased sanctions and publicity from the greater use of criminal, as opposed to civil, sanctions.

Although increased exemplary prosecutions would be an inefficient way to secure increased compliance among major tax cheats, strategies focusing on increased publicity have promise, especially when combined with numerous enforcement options that could have a high return on investment. Indeed, the problem is not a lack of criminal prosecutions but a widespread anti-tax and anti-Internal Revenue Service (IRS) sentiment that emboldens politicians—even ones who “spout law and order”—to “handcuff the tax police” (Johnson, 2005: 4) and hobble enforcement. Ultimately, anti-tax and anti-IRS vilification can lead to backlash and security issues that need to be weighed against the benefits of deterrence. At the same time, an increased use of criminal sanctions might be justified because “fairness matters” (Levi, 2010) for securing widespread voluntary taxpayer compliance and for reducing rampant class bias (Barak, Leighton, and Flavin, 2011; Reiman and Leighton, 2010). But fairness is not well defined in relation to voluntary compliance, and it raises questions about the importance of the legitimacy of the tax system—questions that go beyond tax administration to activities of government,

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such as bailing out reckless financial institutions and redistributing taxpayer money to them (and their executives).

Given that a celebrated tax protest—the Boston Tea Party—led to America’s independence, anti-tax sentiment has a cultural resonance that can be coupled with a tendency to see “the government” as a “catch-all phrase for the oppressor, the deceiver, the denier of dreams” (Barry, 2010). So, tax fraud should not be perceived as a crime against “the government” but as an improper transfer of money to tax cheats from the current and future American public. The public suffers higher taxes and fewer public services; future generations also are harmed because frauds increase the national debt (government expenditures minus tax collection revenue), which is financed through bonds for which the interest rate compounds the original amount of the fraud. Finally, financing our national debt requires bond purchases by foreign governments, especially China. Thus, although the fraud is not solely responsible for the national debt, it contributes to our country becoming increasingly dependent on China and beholden to its good will—a harm outside the traditional view of victimization but still significant for our posterity.<sup>1</sup>

### **Exemplary Prosecutions, Adverse Publicity, and Anti-IRS Backlash**

The IRS uses substantial resources to prosecute tax resisters who challenge the legitimacy of government taxation. Some of these cases—like the prosecution of actor Wesley Snipes—involve substantial sums of money, but more typically, the legal precedent is the main concern.<sup>2</sup> Outside of “idiot legal arguments” about why tax collection is illegal (Sussman, 1999), major tax fraud is the province of wealthy individuals, small businesses, and corporations bilking the government out of tax revenue by failing to file a tax return, under-reporting income, and not remitting payroll taxes (GAO, 2008a, 2008b). However, “tax administrations will never be able to collect every dollar of tax due. In fact, it can be argued that this should not be the goal since the measures required to do this would be so intrusive as to lead taxpayers to revolt” (HMRC, 2009: 16). Thus, the question is about the role of deterrence in closing the tax gap while being mindful of backlash against tax collection.

Review of the efficacy of deterrence leads to findings that serious violent criminals do not seem to be deterred by increased penalties (Donohue, 2009), so it is unclear to what

1. Because of the serious harm from major tax fraud, having “noncompliance” enter popular usage would be a form of class bias given that no “serious welfare non-compliance” label exists for the poor; popular and political discourse angrily refers to welfare cheats and frauds. In both cases, people fail to perform legal duties to disclose information truthfully so they can transfer money improperly from the public.
2. Snipes was sentenced to 3 years in prison for three misdemeanor counts of failing to file tax returns but was acquitted of felony charges of tax fraud because he relied on the advice of an accountant for an anti-tax organization. The decision follows *Cheek v United States* (498 U.S. 192 [1991]) that a good-faith misunderstanding of the law, even if not objectively reasonable, negates the required statutory element of willfulness. In dissent, Justice Blackmun noted: “[I]t is incomprehensible to me how, in this day, more than 70 years after the institution of our present federal income tax system . . . any taxpayer of competent mentality can assert as his defense to charges of statutory willfulness the proposition that the wage he receives for his labor is not income, irrespective of a cult that says otherwise” (498 U.S. at 210). Buchanan (2010) added that “Congress has passed laws requiring the IRS not to use disparaging language to describe” tax protesters and what others call their “idiot legal arguments” (Sussman, 1999).

extent serious tax fraud can be deterred. As an economic crime, major tax fraud—especially by corporations—is probably closer to rational choice assumptions than violent crime is, in which case increasing the *certainty* of detection is more powerful than increasing the severity of penalties. Thus, the cost-effective strategy for reducing the tax gap would involve increasing the reporting and matching of financial information, more audits, more timely filing of tax liens for businesses delinquent in paying payroll taxes, and more resources for the IRS to “immediately begin collection actions against all of its high-priority cases” (GAO, 2008b: 8). Several states have had success with publicizing the names of individuals and corporations that have the largest unpaid tax bills (GAO, 2008a), which is a strategy that might substitute for the publicity of the criminal prosecution noted by Levi (2010).

More generally, the GAO (2008a) identified numerous strategies in which minimal enforcement efforts could generate substantial revenue. Their analysis frequently notes “limited resources,” and the larger context is that “politicians know a good applause line when they see it, and pledges to reduce taxes too easily slide into efforts to reduce the enforcement powers of the IRS” or its operating budget (Buchanan, 2010). Although this issue might seem political, Levi’s model (2010: Figure 1, bottom box), includes both the governance of tax collection and political interference.

The contemporary anti-tax and anti-IRS vilification suggests that any benefits from increased deterrence need to be weighed against the costs of backlash, a point especially salient because earlier this year a man flew an airplane into an IRS building in Austin, Texas, killing himself, one IRS employee, and injuring 13 others. Like 9-11 and McVeigh’s bombing of the federal building in Oklahoma City, people condemned the violence; but unlike the other events, the attack on the IRS triggered an outpouring of anti-government, anti-tax, and anti-IRS sentiment (Buchanan, 2010). Disturbingly, the sentiment is not just talk, as evidenced by a post-Austin tragedy headline, “Attacks on IRS and its employees are all too common” (O’Keefe, 2010). Although rule enforcers are frequently not popular, people who are anti-IRS are not necessarily anti-police, so coming to a better understanding of the relationship among anti-IRS, anti-government, and law-and-order sentiments could help with IRS security and with making sense of political interference with a vital government function.

### **Class Bias/Fairness Matters**

Levi (2010) notes that “fairness matters,” and a federal joint forum on tax compliance has elaborated on this: “[S]ome enforcement actions may have low returns on investment, such as many criminal prosecutions, but nevertheless be necessary both for fairness and to encourage voluntary compliance” (GAO, 2008a: 12). Although this formulation minimizes the connection between fairness and voluntary compliance, others see a direct, causal impact: “Tax evasion can create unfairness and can fuel perceptions of rampant cheating that undermine respect for government. Left unchecked over time, these perceptions would tend to snowball as more people conclude that cheating is common, normal, and inviting” (Jrank.org, 2010: para 2).

The GAO itself noted that failure to enforce payroll tax laws quickly gives “the non-compliant business an unfair competitive advantage. . . . Businesses that fail to remit payroll taxes may also under bid tax-compliant businesses, causing them to lose business and encouraging them to also become non-compliant” (2008b: 26). Moreover, “allowing businesses to continue to not remit payroll taxes affects the general public’s perception regarding the fairness of the tax system, a perception that may result in lower overall compliance” (2008b: 26). A recent GAO (2009a: i) report noted that “fairness is believed to undergird voluntary compliance,” and it recommends a comprehensive evaluation of the administration of civil tax penalties on voluntary compliance—a suggestion that also should apply to criminal penalties. Such research is overdue and could help ensure that penalties are set appropriately and administered consistently.

However, implementing a policy based on fairness should require no specific outcome, such as increased voluntary compliance. Our conceptions of the rule of law and constitutional requirements of equality do not allow for class bias, and the substantial evidence of class bias in the criminal justice system (Barak et al., 2011; Reiman and Leighton, 2010) supports a presumption of bias in applying criminal sanctions in tax administration. Indeed, as Braithwaite noted (2003: 14), “just deserts theorists worked hard at refusing to confront the implications of applying a just deserts philosophy to tax and consumer fraud where tens of millions of offenses are detected each year of frauds involving much greater amounts of money than the average blue collar theft”. He added that retributivists and the sociologists of punishment tend to be “only really interested in the punishment of the poor, so both failed to play any critical role in exposing hypocrisy with respect to the crimes of the powerful” (2003: 14), especially corporations. Policy makers generally have followed suit, mostly increasing punishments for white-collar crimes at times—like the economic collapse surrounding Enron—when the crisis threatens the legitimacy of the state. If fairness requires an increased use of criminal sanctions for the wealthy and businesses (or a decreased use of criminal sanctions for the poor), then we should embrace the actions necessary for justice simply because they are necessary for justice.

Because policy makers are likely to be more interested in outcomes like increased voluntary compliance than equality, future analysis should start with the assumption that fairness is not merely a matter of whether the overall administration of tax collection involves class bias. The broader question of the legitimacy of tax collection also depends on whether tax collection supports a government that is perceived as working in the interests of all.<sup>3</sup> More pointedly, the question would be how voluntary compliance will be affected by the bailout of the financial sector (Ritholtz, 2009a; Smith, 2010) and by the redistribution of wealth from taxpayers to

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3. This analysis connects with the cultural resonance surrounding the airplane flying into the IRS building. Kooistra (1989: 11) suggested that hero status is bestowed on a criminal when people find “some symbolic meaning in his criminality,” and support for the symbolic meaning happens “when substantial segments of the public feel themselves to be ‘outside the law’ because the law is no longer seen as an instrument of justice but as a tool of oppression wielded by favored interests.”

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executives of companies receiving taxpayer money through the Troubled Asset Relief Program (TARP).<sup>4</sup>

### **Conclusion and Recommendations**

The discussion so far has attempted to explore some important threads in Levi's (2010) article, and the final task is to focus the analysis into policy recommendations. Although I am skeptical about the cost-effectiveness of a deterrence strategy for closing the tax gap, increased prosecutions are necessary for fairness and have the added benefit of a positive impact on voluntary compliance. Increased enforcement for either deterrence or fairness has the potential for increased backlash and anti-IRS sentiment, but enforcement for the sake of deterrence—a "scared straight" program for tax cheats—is different from promoting equality in tax administration and criminal justice. Having tax collection be but one example of a multifaceted plan to heighten equality before the law would reduce some (but not all) of the negative consequences. Any necessary increase in IRS security would be a small price to pay for a substantively fairer society and increased voluntary compliance; it would be a drop in the proverbial bucket compared with the resources the United States spends to defend—and impose—its ideas around the world.

### ***Exemplary Prosecution and Adverse Publicity***

Exemplary prosecutions are likely to be an inefficient way to secure compliance. Better goals would involve increasing the certainty of apprehension combined with the tools to make it "easier for people to be good" (Tiftt and Sullivan, 2001: 180). For example, sending information and worksheets and offering the opportunity to redo portions of taxes to those who are out of compliance is both productive (GAO, 2008a) and humane—especially for those cheating because of economic difficulties; it also might help to identify those who are willfully cheating. In addition to many GAO recommendations that can be culled easily for high return-on-investment strategies (GAO, 2008a, 2008b), the IRS code should be changed so that it can follow the 19 states that publicize the names of those with delinquent tax bills. The GAO (2008b: 19) noted that "just threatening to publish the names of tax offenders can bring some into compliance, while actually appearing on a tax offender list can bring about societal pressure to comply." And it "may also encourage greater tax compliance among the general population of taxpayers to avoid potentially being on the list" (2008b: 19).

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4. New York Attorney General Andrew Cuomo reported that Citigroup and Merrill Lynch together "lost \$54 billion, paid out nearly \$9 billion in bonuses and then received TARP bailouts totaling \$55 billion" (Cuomo, 2009: 1). Other companies did not lose money but paid out more in bonuses than they made in income. Goldman Sachs, Morgan Stanley, and J.P. Morgan Chase together "earned \$9.6 billion, paid bonuses of nearly \$18 billion, and received TARP taxpayer funds worth \$45 billion" (Cuomo, 2009: 2).

### ***Greater Investment in Research***

The political reality of high deficits and President Obama's increased budget request for the IRS (GAO, 2009b) mean increased enforcement is coming, and the head of the office of the Treasury Inspector General for Tax Administration (which handles threat and assault case referrals) said, "There is a direct correlation between increased IRS enforcement efforts and the number of threats made against IRS employees" (O'Keefe, 2010). In this environment, research is important for a better understanding of the constellations of beliefs that are anti-tax, anti-IRS, and anti-government. Research findings should be of a nature that they can be applied to strengthen IRS security (and provide a basis for evaluating the applicability of research and strategies from other countries to the United States). The nature of *Criminology & Public Policy* is to advance policy and not simply to provide the standard academic call for more research, but where key research is lacking, an important policy goal can be to stimulate it, and anti-government beliefs are part of right-wing extremism that was largely ignored under the Bush presidency.

Furthermore, the existing effort to evaluate the effect of civil tax sanctions should be expanded to include criminal sanctions. The "IRS said that such a plan was important in understanding the relationship between penalty administration and voluntary compliance and in identifying priorities and potential resource needs" (GAO, 2009a: 16). Because "developing a comprehensive plan may take time" (2009a: 16), it is not too late to add an evaluation of criminal penalties and achieve some economies of scale by undertaking both evaluations simultaneously. Both projects must include, even focus on, high-end tax evasion by individuals and corporations.

### ***Legitimacy and Voluntary Compliance***

Equalizing civil and criminal sanctions is important but not enough to increase the legitimacy of tax collection. Given huge deficits from bailing out a reckless financial sector and the redistribution of public money to the wealthy, serious financial reform is necessary to increase voluntary compliance by demonstrating that the government is working in the public interest rather than for special favored interests. Indeed, preventing (or at least mitigating the impact of) economic crises is better for the national debt than bailouts and stimulus spending. Unfortunately, popular anger has dissipated, and financial firms have poured hundreds of millions into Congress to stop meaningful reform. Because the outcome of this opportunity for major financial reform is questionable (Ritholtz, 2009b, 2010), future reform efforts could benefit by studying Finland, which made a "decision of principle to fight economic crime" in 1996 and has had a series of action plans that have renewed this initiative for a decade (Alvesalo, Tombs, Virta, and Whyte, 2006). "Raising economic crime as an economic, social and crime problem, one which causes damage to the material and moral fabric of Finnish society, the Action Plans consist of a series of reforms in legislation, regulatory organisation, enforcement practice, and research activities" (Alvesalo et al., 2006: 9).

These action plans included tax evasion as part of a systemic package to deal with economic crime. Interestingly, the “triggering event” was the recession at the start of the 1990s, known in Finland as ‘the Great Depression’:

Unemployment rose from 3% in 1990 to 20% by 1994, real wages fell, and, from a balanced budget in 1990, the Finnish central government budget was in deficit by . . . over 12% of GDP. In terms of causes, amongst other reasons mismanagement on the part of both Government and the Bank of Finland was perceived as crucial, as were a series of bank failures—with some of the latter being popularly attributed to crime and illegality on the part of owners, directors, and managers of banks and other private companies. . . . At the same time, the Government committed enormous expenditures to rescuing the banking industry from near-collapse. Further, the legacy of depression was an enduring one—for example, it has left unprecedented, high levels of unemployment (Alvesalo et al., 2006: 10).

When the next major financial crisis happens, concerned citizens and policy makers should be ready to move with something along the lines of the Finnish Action Plan. The time to start assembling the policy pieces is now, and hopefully *Criminology & Public Policy* can be a significant forum for such efforts.

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