



Behavioral Economics, IRS Letter Campaigns, and Tax Compliance

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Research from the fields of behavioral economics and behavioral science suggests there may be cost-effective ways for the Internal Revenue Service (IRS) to increase tax compliance and collections. This Insight discusses one relatively simple approach to potentially increase compliance: carefully crafted letters to taxpayers. The discussion below is also intended to introduce the reader to a small portion of the vocabulary used by behavioral economists.

Classical and Behavioral Theories

According to the most [recent estimates](#), the IRS collects about 84% of the taxes it should be collecting. The [classical economic theory](#) of tax compliance assumes that “rational” individuals purposefully compare the expected *monetary* costs and benefits of gaming the tax system, and that compliance can be increased by increasing audits, increasing penalties, or a combination of the two. In contrast, [behavioral theories](#) of tax compliance question whether people are the rational beings that the classical theory assumes, and also propose that individuals consider the *psychological* or *moral* costs of not complying with the tax code as well as the monetary costs. Additionally, researchers have observed that individuals are prone to making honest mistakes when completing complex tasks, which completing a tax return may be for some people.

An Effective Letter Campaign

Economists [have found](#) that carefully crafted letters can encourage individuals to comply with the tax code. The tax system can be complex and difficult to understand, and individuals are susceptible to information overload and confusion—what behavioral economists refer to as “[bounded rationality](#)”—because of cognitive limits on memory, computation capacity, and the ability to process information. One suggestion behavioralists have is the use of clear and concise writing in “plain English” when communicating with taxpayers. Reader-friendly letters can reduce the cognitive load placed on everyday taxpayers and increase the likelihood that they comply with the tax code.

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How a letter's message is [framed](#) can also influence its impact by leveraging certain tendencies, or "biases" in behavioral jargon, that humans display when making decisions. A tendency for people to focus on the most prominent information in a message, known as the [saliency bias](#), suggests the use of bold text or bright colors to emphasize information that is critical to an individual's situation. For example, a delinquent tax letter may emphasize the text that states the amount of unpaid taxes, penalties, deadlines, and steps to resolve the matter. Providing a webpage where an individual may obtain additional information or assistance reduces the amount of information the reader must absorb and generally increases the effectiveness of the letter's central message.

A tendency for individuals to behave within [social norms](#) suggests ways to frame a letter to increase the psychological cost of not complying with the tax code. [Researchers in the UK](#) were able to increase tax compliance by framing an individual's behavior in relation to the behavior of other taxpayers. The researchers sent 100,000 individual taxpayers letters that included one of five randomly selected messages. Three of the messages were as follows:

1. "Nine out of 10 people pay their tax on time." (referred to as the basic norm)
2. "Nine out of 10 people in the UK pay their tax on time." (country norm)
3. "Nine out of 10 people in the UK pay their tax on time. You are currently in the very small minority of people who have not paid us yet." (minority norm)

Although each letter contained essentially the same information—that recipients had not paid their taxes and that the overwhelming majority do—the language used in the minority norm version was found to produce the largest increase in compliance. The minority norm language may have been most effective because it struck a more personal chord and more clearly highlighted how the individuals' behavior departed from social norms. One theory as to why social norms may influence people's behavior is that people wish to maintain a positive self-image, and behaving within the norms displayed by other allows an individual to do this. The desire to view oneself favorably falls under the more general umbrella of [identity economics](#) and is closely related to what noted economist and psychologist [Dan Ariely](#) calls a [personal fudge factor](#), or the idea that people engage in dishonest behavior to the extent they can still feel good about themselves.

The other two messages used in the study were intended to investigate whether highlighting the connection between revenue collection and the financing of public goods and services had any meaningful impact on noncompliance. Tax compliance was found to increase in response to such statements, suggesting tax administrators may want to consider messages that clearly connect complying with the tax code to important public programs that taxes support, such as education, military, and infrastructure spending.

Looking Forward

The field of behavioral economics' influence on public policy has been growing in recent years across a wide range of policy areas. [Governments around the globe](#) have established or work closely with behavioral research organizations to assist in the formulation and design of public policies. In the United States, the IRS partnered with private consultants to develop a [Behavioral Insights Toolkit](#) to assist its employees in serving taxpayers and achieving its mission.

One potentially fruitful avenue to pursue with tax compliance is combining behavioral economics with big data analytics. The IRS has a vast archive of taxpayer data that it could use to identify taxpayers who may fail to comply with the tax code before doing so. They could also predict why an individual has a high probability of being noncompliant. For example, if a taxpayer previously missed a filing deadline, the IRS could send a letter during the tax filing

season reminding the individual of the deadline. Alternatively, if a taxpayer is predicted to likely underreport income, a letter highlighting the consequences of not accurately reporting income could be sent before the individual files.

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