

NBER WORKING PAPER SERIES

TAX AUDITS AS SCARECROWS:  
EVIDENCE FROM A LARGE-SCALE FIELD EXPERIMENT

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Working Paper 23631  
<http://www.nber.org/papers/w23631>

NATIONAL BUREAU OF ECONOMIC RESEARCH  
1050 Massachusetts Avenue  
Cambridge, MA 02138  
July 2017

We thank the Tax Registry of Uruguay for their collaboration. We thank Gustavo Gonzalez for his support, without which this research would not have been possible. We thank Joel Slemrod for his valuable feedback, as well as that of seminar participants at the 2017 RIDGE Public Economics Conference and the 2017 Zurich Center for Economic Development Conference. This project benefited from funding by CEF, CEDLAS-UNLP and IDRC. The views expressed herein are those of the authors and do not necessarily reflect the views of the National Bureau of Economic Research.

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Tax Audits as Scarecrows: Evidence from a Large-Scale Field Experiment  
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NBER Working Paper No. 23631  
July 2017  
JEL No. C93,H26,K42

### **ABSTRACT**

According to the canonical model of Allingham and Sandmo (1972), firms evade taxes by making a trade-off between a lower tax burden and higher expected penalties. However, there is still no consensus about whether real-world firms operate in this rational way. We conducted a large-scale field experiment, sending letters to over 20,000 firms that collectively pay over 200 million dollars in taxes per year. In our letters, we provided firms with exogenous but nondeceptive signals about key inputs for their evasion decisions, such as audit probabilities and penalty rates. We measure the effect of these signals on their subsequent perceptions about the auditing process, based on survey data, as well as on the actual taxes paid, according to administrative data. We find that firms do increase their tax compliance in response to information about audits. However, the patterns in these responses are inconsistent with utility maximization. The evidence suggests that, much like scarecrows frighten off birds, audits can be a significant deterrent for tax evaders even though they would be perceived as harmless by a rational optimizer.

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# 1 Introduction

Tax audits have been standard tools of most tax administrations throughout history. Besides the proceeds of actual inspections, the mere threat of an audit can be a powerful device to ensure compliance. In fact, the probability of being audited is one of the key parameters in Allingham and Sandmo's (1972) canonical model of tax evasion. In this framework, taxpayers are modeled as selfish and risk-averse criminals (Becker, 1968) who choose how much income to conceal from the tax authority by comparing the costs (i.e., the penalties to be paid if caught) and benefits (i.e., the lower tax burden) of evading.

The importance of tax audits for tax evasion decisions, however, might vary for different sources of income. For instance, wage income is hard to conceal in modern economies because employers are usually required to report their employees' earnings to the tax authority. As a result, tax evasion can be detected and deterred even without conducting an audit (Kleven et al., 2011). However, this automatic third-party reporting is limited for other sources of taxable income, such as income from self-employment and firm value-added.<sup>1</sup> For those sources of income, the threat of being audited is supposed to play an important role in deterring tax evasion.

Although there is a consensus that audits and penalties have some positive effects on tax compliance, there is no consensus yet on whether real-world firms react to audits in the optimal manner predicted by Allingham and Sandmo (1972). In this paper, we present evidence from a field experiment designed to understand how firms react to the threat of audits.

In collaboration with the Internal Revenue Services (IRS) from Uruguay, we conducted an experiment with a sample of over 20,000 small- and medium-size firms. The IRS mailed letters to the owners of each of these firms. We randomly assigned the information contained in each of these letters to test specific hypothesis about the role of audits in tax compliance. We measure the effect of this information on behavioral outcomes: the value-added tax (VAT) and other taxes paid by these firms, using the administrative records from the IRS. Additionally, we measure the effect of the information contained in the letter on subsequent perceptions of these firms, such as the perceived probability of being audited and the perceived penalty rate, using survey responses collected nine months after the letters were sent.

We designed several letter types and subtypes. The *baseline* letter type included some brief generic information about taxes that the IRS often includes in its communications with firms. The *audit-statistics* letter type was identical to the *baseline* letter, except for

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<sup>1</sup>While the value added tax (VAT) requires a paper trail, this might reduce but not rule out the possibility or scope of evasion. For once, the paper trail breaks down when reaching the consumer. Moreover, there is evidence that firms can collude to avoid or tamper with the paper trail (Pomeranz, 2015; Naritomi, 2016).

an added message signaling the probability of being audited and the penalty rate, based on tax administration statistics. We can estimate the effect of this information about audits by comparing the posttreatment tax payments of firms assigned to the *baseline* letters to those of recipients of *audit-statistics* letters. According to Allingham and Sandmo (1972), if firms are underestimating audit probability or penalty, giving them this feedback should increase their tax compliance.

However, observing that firms react to unbiased feedback about the auditing process would not imply that firms are making an optimal cost–benefit calculation as in Allingham and Sandmo (1972). On one extreme, it is possible that firms are rationally learning from the information about audits and changing their behavior because they are re-optimizing under the new beliefs. On the other extreme, firms may be reacting to the information because it triggers an irrational feeling of fear, even if there are no changes in beliefs about the audit probabilities and penalty rates.

To explore the causal mechanisms, we included *audit-statistics* subtreatments that generated exogenous yet nondeceptive variation in information about audit and penalty rates. We computed the average audit probability and penalty rates included in the *audit-statistics* message using a sample of 50 firms randomly selected from those similar to the firm of the letter recipient. The limited sample size used to compute these averages introduced substantial sampling variation in the information included in the letters. For instance, a firm may receive a signal of audit probability of 8% or 15% depending on the sample of similar firms that was drawn for that particular letter. As a result, firms were assigned to 950 distinct combinations of audit probabilities and penalty rates. We exploit this exogenous variation in signals to estimate the behavioral elasticities between tax compliance and the audit and penalty rates.

In a complementary experiment, we used a separate sample of firms that had been preselected by the IRS for audit consideration. We randomly divided these firms into two groups, one that would be audited with a 25% probability and the other that would be audited with a 50% probability. The *audit-threat* letter type included a message informing these firms about the probability to which they had been assigned. This exogenous variation allows for an alternative estimation of the elasticity between tax compliance and the audit probability. However, because of legal and practical considerations, randomizing the penalty rates to which these firms would be subject was not possible.

We included two additional treatment arms of the main experiment pool. In the first one, we explored an additional aspect of the auditing process: the *audit-endogeneity* letter was identical to the baseline letter, except for an added message explaining that evading taxes increases the probability of being audited. According to Allingham and Sandmo (1972), if

firms are unaware of this probability, informing them about this endogeneity should increase tax compliance. In the last treatment arm, we provided a nonpecuniary benchmark for the audit messages. The *public-goods* letter was identical to the baseline letter, except for an added message listing all the public goods that could be provided if firms reduced their tax evasion by 10%. According to the theory of the moral cost of noncompliance, adding this message could increase tax payments of evaders (Cowell and Gordon, 1988).<sup>2</sup>

We find that adding messages related to audits increases tax compliance. Adding a paragraph with statistics about the probability of being audited and the penalty rates increases tax compliance by about 6.3%, and adding a paragraph that indicates the endogeneity of the audit probability increases tax compliance by about 7.4%. These effects are not only highly statistically significant, but also economically substantial. Using the estimated average evasion rate of 26% from Gomez-Sabaini and Jimenez (2012), these effects would amount to a reduction in the evasion rate of 24% and 28%, respectively. Furthermore, these effects are robust to a number of specification checks and alternative outcomes. In comparison, the message about public goods had a smaller and statistically insignificant effect on tax compliance.

The effects of the *audit-statistics* subtreatments shed some light on why firms reacted to the feedback about statistics. Among firms that were sent this type of letter, those receiving higher signals of the audit or penalty rates by chance do not pay significantly higher taxes. Indeed, the average elasticities of tax compliance with respect to audit probability and penalty rate are close to zero, precisely estimated and statistically different from the elasticities predicted by various calibrations of Allingham and Sandmo (1972). The results are similar if we instead use firms assigned to the *audit-threat* letter, which provides an alternative randomization of the probability of audits.

The survey data also favor the fear channel. We find that the *audit-statistics* letter reduced the perceived probability of being audited. Thus, if firms were reacting to the *audit-statistics* letter because of re-optimization, they should have reduced, rather than increased, their tax compliance. Similarly, since most firms were already aware of this information, the effect of the *audit-endogeneity* message is inconsistent with the re-optimization channel.

Our survey also shows that, on average, firms perceive a probability of being audited of almost three times the real probability, but have unbiased beliefs about penalty rates. This finding of overestimation of audit probabilities is consistent with prior survey evidence (Harris and Associates, 1988; Erard and Feinstein, 1994; Scholz and Pinney, 1995). However,

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<sup>2</sup>There is a related literature on the social determinants of tax compliance. For instance, Blumenthal et al. (2001) and Fellner, Sausgruber and Traxler (2013) show that moral suasion messages do not increase compliance, while Perez-Truglia and Troiano (2015) show that social shaming can sometimes be effective.

this previous evidence corresponds to wage-earners, for whom the misperception of audit probabilities is mostly inconsequential owing to third-party reporting (Kleven et al., 2011). Our evidence suggests that these biases persist even when the financial stakes of misperceiving audit probabilities can be substantial.

Our findings suggest that firms may comply with taxes because of the threat of being audited, but not in an optimal manner as in Allingham and Sandmo (1972). Our evidence suggests two relevant sources of frictions. First, tax compliance being elastic with respect to the visibility of audit statistics but inelastic with respect to the audit probability and penalties suggests significant optimization frictions. Second, the fact that firms have large dispersion and biases in beliefs about audits, with most of these misperceptions persisting even after firms are provided with accurate information, suggests information frictions.

Our findings contribute to the debate about the determinants of tax compliance. Some take the failure of the Allingham and Sandmo (1972) model to predict evasion rates as an indication that tax compliance does not largely depend on tax enforcement but on other factors such as tax morale (Luttmer and Singhal, 2014). Our evidence suggests that tax enforcement could still be important, just not in the fully rational way in which Allingham and Sandmo (1972) modeled it. In other words, much like scarecrows frighten off birds, audits could be a significant deterrent for tax evaders even though they would be perceived as harmless by a rational optimizer.

This paper belongs to various strands of literature. First, it contributes to a growing literature that uses field experiments to study the decision of individuals to pay taxes. In a seminal contribution, Slemrod, Blumenthal, and Christian (2001) showed that, for a sample of U.S. self-employed individuals, those who were randomly assigned to receive a letter from the Internal Revenue Services with an enforcement message reported higher income in their tax returns. Similar messages about tax enforcement have been shown to have positive effects on compliance in a variety of contexts: wage income taxes in Denmark (Kleven et al., 2011), individual public-TV fees in Austria (Fellner, Sausgruber and Traxler, 2013), firms' VAT payments in Chile (Pomeranz, 2015), individual municipal taxes in Argentina (Castro and Scartascini, 2015), and an individual church tax in Germany (Dwenger et al., 2016). We contribute to this literature by disentangling the precise mechanism through which the threat of audits affects tax compliance. Our results indicate that the threat of audits matters, even though precise information such as the probability of audits and the penalty rates do not.<sup>3</sup>

Our analysis uses a subject pool similar to that of Pomeranz (2015). She shows that, compared to firms that received a placebo letter, firms that received a letter mentioning the

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<sup>3</sup>These results are consistent with abundant evidence on the importance of salience for tax avoidance (Chetty, Looney and Kroft, 2009).

possibility of being audited increased their VAT payments. Pomeranz (2015) then uses that exogenous variation in payments to measure how the higher tax payments spill over to other firms in the value-added chain. We instead focus on understanding the mechanisms through which letters with information about audits, such as ours or those in Pomeranz (2015), affect the tax payments of the recipients in the first place.

From the perspective of experimental design, our work is related to Kleven et al. (2011) and Dwenger et al. (2016). In one treatment arm in their experiment, Kleven et al. (2011) show that randomizing employed individuals to a higher audit probability (100% instead of 50%) increases their tax compliance by an amount that is statistically significant but economically negligible. However, their findings do not constitute evidence against Allingham and Sandmo (1972) because they conduct these experiments with wage earners, for whom evasion is almost always automatically detected through automatic third-party reporting and without the need of audits, and who thus should not rationally care much about the probability of audits. In another experiment, Dwenger et al. (2016) show that announcing different probabilities of audits does not have a statistically significant effect on compliance with a small local church tax in Germany; however, because of statistical power they cannot rule out economically significant effects.

This paper also belongs to a literature that tries to evaluate the fit of the Allingham and Sandmo (1972) model. The evidence based on calibration exercises suggests that Allingham and Sandmo (1972) would predict substantially lower tax compliance than that observed in the United States (e.g., Alm, McClelland, and Schulze, 1992). Other studies rely on regression analysis based on observational data. For example, Beron, Tauchen, and Witte (1988) find a weak correlation between the probability of being audited and reported income. Dhimi and al-Nowaihi (2004) suggest the addition of behavioral features, such as stigma cost and prospect theory, to improve the fit of the Allingham and Sandmo (1972) model. Finally, a group of studies explores these issues in laboratory settings. Most notably, Alm, Jackson, and McKee (1992) show that taxpayer reporting increases with audit and penalty rates, but the magnitudes of these reactions in the laboratory are smaller than those predicted by Allingham and Sandmo (1972).

The paper is organized as follows. Section 2 discusses the relevant hypotheses and the experimental design used to test them. Section 3 presents the data sources and discusses the implementation of the field experiment. Sections 4 and 5 present the results. The final section concludes.

## 2 Hypotheses and Experimental Design

### 2.1 Baseline Letter

Our experiment consisted of a mailing campaign from Uruguay’s IRS, which included a number of treatment and subtreatment arms. Rather than comparing firms that received a letter to firms that did not, all of our analysis is based on comparisons between firms that received letters, but with subtle variations in their content. We can thus net out the potential effects of simply receiving a letter from the tax authority, which might for instance induce a reminder to pay due taxes.

These letters consisted of a single sheet of paper with the name of the recipient in the header, the official letterhead of the IRS, and the hand signature of the General Director of the IRS. These letters were folded and placed in an envelope sealed with the official identification of the IRS and sent by certified mail, which guarantees that the letters are delivered directly to the recipient, who must sign upon receipt.

The first type of letter is the *baseline* letter, a sample of which is provided in Appendix A.1. The *baseline* letter contained some information that the IRS routinely includes in its communications with firms about the goals and responsibilities of the tax authority. The text explained that the individual was randomly selected to receive this information, the letter was for information only, and there was no need to reply or to present any documentation to the IRS. The letters in other treatment arms included the same text as the *baseline* letter as well as a distinct paragraph dependent on the arm. The additional paragraphs were presented in a larger type size and in boldface.

### 2.2 Audit-Statistics Letter

The goal of this treatment arm is to generate exogenous variation in the firms’ perceptions about audit probabilities and penalty rates. Because of legal constraints, we could not assign different firms to different penalty rates. In Uruguay, as in most of the world, individuals cannot be punished differently for the same crime. To circumvent this situation, we create exogenous variation in information that may affect perceptions about penalties, in a nondeceptive way, by exploiting sampling variation in statistics about audits.

In the *audit-statistics* letter type, we provided firms with information about the audit and penalty rates. According to the Allingham and Sandmo (1972) model, we would expect risk-averse firms to be interested in this information because it would help them optimize their evasion decisions and potentially increase their bottom line.<sup>4</sup> Furthermore, this infor-

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<sup>4</sup>We assume that firms in our sample are risk averse, which is plausible since we deal mainly with small

mation would seem to be particularly valuable in the context of limited information about audits. For instance, it is easy to find information online about factors potentially relevant for firms' decision-making, such as the inflation rate or exchange rates. However, it is virtually impossible to find online any information about audit probabilities and actual penalties paid by evading firms—tax authorities seem to prefer to conceal this information.

Uruguay's tax law indicates that tax audits should cover the previous three years of tax returns. As a result, the probability that this year's tax report will be audited is equal to the probability that the firm gets audited at least once over the next three years.

Appendix A.2 presents a sample of the *audit-statistics* letter type. Compared to the *baseline* letter, it contained an additional paragraph with information about the audit probability ( $p$ ) and penalty rates ( $\theta$ ) for a random sample of firms similar to that of the recipient. :

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

In our sample, the average value of  $p$  is 11.7%, while the average value of  $\theta$  is 30.6%. Tax agencies do not publish data on the values of  $p$  and  $\theta$  in their countries, which makes it difficult to compare the Uruguayan case to other contexts. In the United States, for which some comparable data are available, these two parameters are on the same order of magnitude: self-employed individuals face  $p=11.42\%$  and  $\theta=20\%$ .<sup>5</sup>

The addition of the *audit-statistics* message to the *baseline* letter may induce a positive or negative effect on tax payments through two potential mechanisms. On the one hand, firms might change their beliefs about  $p$  and  $\theta$  and rationally re-optimize their evasion decision based on the new beliefs. If these messages increase firms' perception of  $p$  (or  $\theta$ ), they should increase their tax payments. To the contrary, if this information reduces the firms' perceived values of  $p$  (or  $\theta$ ), then they should reduce their tax payments. On the other hand, providing firms with the information about audit probabilities and penalty rates may scare firms into reducing their tax evasion, even if there was no cost-benefit analysis of the information.

To distinguish between these two mechanisms, we introduced exogenous variation in the values of  $p$  and  $\theta$  shown in our treatment letters. To avoid any deception, we included a

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<sup>5</sup>First, there is an annual probability of being audited of 2.1%, according to the ratio of returns examined for businesses with no income tax credit and with a reported income between 25,000 and 200,000 USD (Table 9a of IRS, 2014). Each audit covers the previous 3 to 6 years, which implies that the the probability that the current year's tax filing will be eventually audited ranges from 5.88% to 11.42%. Second, IRS usually imposes a basic penalty of  $\theta=20\%$ , although the penalties can be higher in severe cases.

footnote in the letter to detail how we had estimated the values of  $p$  and  $\theta$ :

“Estimates are based on data from the 2011–2013 period for a group of firms with similar characteristics in terms of, for instance, total revenue. The probability of being audited was calculated as a percentage of audited firms in a random sub-sample of firms. The rate of the fee was estimated as an average of a random sub-sample of audits.”

More specifically, we divided the firms into quintiles based on total sales revenues. For each firm we then drew a random sample of 100 other firms from the same quintile (i.e., “similar firms”), from which we computed the averages of  $p$  and  $\theta$ . This randomization strategy led us to 940 different combinations of  $p$  and  $\theta$ . These estimates of  $p$  and  $\theta$  were unbiased and consistent with the explanation given in the footnote—the information provided to the recipients was thus nondeceptive.

Figure 1 shows a histogram of the values of  $p$  and  $\theta$  included in these letters. The values of  $p$  range from 2% to 25%, with an average of about 11.7%. The values of  $\theta$  range from 15% to 66%, with an average of about 30.6%. A small share of this variation in  $p$  and  $\theta$  (13.6% and 0.9%, respectively) derives from the fact that firms belonged to different reference groups (i.e., different quintiles of sales revenues). The rest of the variation is the result of sampling variation.<sup>6</sup>

The goal is to compare the tax payments among firms that were assigned different values of  $p$  and  $\theta$  by chance. A lack of reaction to these different levels of  $p$  or  $\theta$  would suggest that fear was the main channel through which firms reacted to the *audit-statistics* message. If, instead, this variation in the values of  $p$  and  $\theta$  in our treatment letters had an effect on tax compliance, we could infer that recipients learned from the information provided and re-optimized their behavior based on their updated posterior beliefs. We present below a comparison between the effects of our mailing campaign and the magnitude of the impact derived from a calibration of the Allingham and Sandmo (1972) model.

As a second strategy for disentangling between the fear and re-optimization mechanisms, we conducted a survey of recipients (described in detail in Section 3.5). This survey allows us to assess whether they had incorporated the information provided to them in the letter. We captured the effects of the information contained in the *audit-statistics* letters on beliefs by means of the two following survey questions:

Perceived Audit Probability: “In your opinion, what is the probability that the

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<sup>6</sup>To obtain the proportion of the variation corresponding to the clustering size, we regress each parameter on the quintiles of sales revenues. Regressing  $p$  over VAT sales quintiles results in  $R^2 = 0.136$ , while regressing  $\theta$  over the same variables results in  $R^2 = 0.009$ .

tax returns filed by a company like yours will be audited at least in one of the next three years (from 0% to 100%)?”

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

## 2.3 Audit-Threat Letter

To complement the evidence from the *audit-statistics* subtreatments, we conducted an alternative way of randomizing perceptions about audit probabilities. We devised a treatment arm called *audit-threat* letter that randomly assigned firms to groups with different probabilities of being audited, with a certain probability in the following year. A sample of the audit-threat letter is presented in A.3. The *audit-threat* letters were identical to the *baseline* letter, except for the following additional paragraph:

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

We devised this treatment arm with the IRS audit department, which specified a group of high-risk firms, randomly assigned them to two groups, and committed to carry out audits on 25% of the firms in one of the groups and 50% of the firms in the other group, yielding two randomly assigned probabilities of audit in our letters of  $X=25\%$  and  $X=50\%$ . If these letters affected the recipients’ perceptions of the audit probability rather than simply generating a fear of audits, those randomly assigned to the 50% probability should report higher taxes than those assigned to the 25% group.

This *audit-threat* treatment arm was applied to a different sample of high-risk firms from that of the rest of the experiment. These different experimental samples imply that the effects of the *audit-threat* treatment arm cannot be directly compared to those of the *baseline* letter. We use this treatment arm as a separate auxiliary experiment.

## 2.4 Audit-Endogeneity Letter

Most tax agencies, including Uruguay’s, take into account firm characteristics when deciding which ones to audit. They assign higher audit probabilities to firms that are considered to have a higher probability of evading. As a result, evading taxes typically increases the

probability of being audited. In the canonical model of tax evasion, the audit probability is exogenous, but several authors, such as Allingham and Sandmo (1972), Andreoni et al. (1998), Yitzhaki (1987), and Slemrod and Yitzhaki (2002), introduce variations of the model in which the audit probabilities are determined endogenously. In the context of these models, if unsuspecting firms receive news about the endogeneity of audits, they should revise their tax evasion decisions and reduce the amount of tax evaded.<sup>7</sup>

To explore this hypothesis, we designed the *audit-endogeneity* treatment arm. We asked our counterparts at the IRS to split a small sample of firms into ones suspected of evading taxes and ones not suspected of evading at taxes, according to the IRS’s scoring data on firms’ evasion risk. We then computed the difference in 2011–2013 audit rates between the two groups and found that the rates were approximately twice as high for the latter group. We used this information to create the *audit-endogeneity* letter type, which adds to the *baseline* letter the following paragraph (see sample in Appendix A.4):

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

As with the other treatment arms, we estimate whether recipients of these letters paid more taxes than those in the *baseline* group. As in the *audit-statistics* treatment arm, two mechanisms could be at play with this *audit-endogeneity* letter. On the one hand, tax compliance may increase when firms internalize the fact that audits are endogenous to their evasion behavior—the importance of their own actions becomes more palpable. On the other hand, firms may re-optimize their tax compliance decisions incorporating the information we provided about how audits change as a function of their behavior. If, on average, recipients revised their beliefs about the degree of endogeneity of audits upward (downward), the latter mechanism should increase (decrease) their tax compliance.

As with the *audit-statistics* treatment, we included question in the survey intended to measure the subject’s awareness about the endogeneity of audit probabilities—this question and its results are described in detail in Appendix C.3.

## 2.5 Public-Goods Letter

In line with previous studies (see e.g., Blumenthal et al., 2001; Fellner et al., 2013; Dwenger et al., 2014; Pomeranz, 2015), we devised a treatment arm that could provide a benchmark

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<sup>7</sup>Konrad et al. (2016) present suggestive evidence of this mechanism in the context of a lab experiment: taxpayers facing a situation where suspicious attitudes toward tax officers increase the probability of being audited increase their tax compliance by 80%.

for the effect of nonpecuniary incentives on tax compliance. In coordination with IRS staff and authorities, we compiled the message that we believed would be the most effective at increasing compliance. This is a message about the cost of evasion in terms of public good provision, in the spirit of the model of Cowell and Gordon (1988).<sup>8</sup>The *public-goods* letter is identical to the *baseline* letter, with the exception of the addition of a specific paragraph. The paragraph lists a series of services that the government could provide if tax evaders reduced their evasion by 10% (see Appendix A.5 for a sample of the letter):

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

We used estimates from different governmental agencies to design this message.<sup>9</sup> As with the other treatment arms, we can test whether the *public-goods* letter increased tax compliance compared to the *baseline* letter. A possible channel is that this message induces a moral cost of evasion and thus reduces noncompliance. An alternative channel linking this type of message and evasion behavior is that firms may revise their beliefs about the social cost of evasion. An upward revision should increase their tax compliance, and a downward revision could reduce it.

## 3 Data Sources and Implementation of the Field Experiment

### 3.1 Institutional Context

Uruguay is a South American country with an annual GDP per capita of about USD 15,000 in 2015. Total tax revenues (i.e., for all levels of government) were about 19% of GDP in

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<sup>8</sup>This message is also related to the laboratory experiment from Alm, McClelland, and Schulze (1992), which presents evidence that one of the reasons why people decide to pay taxes is their valuation of the public goods provided with the tax revenues.

<sup>9</sup>These agencies were: Administracion Nacional de Educacion Publica (ANEP), CEIBAL, Ministerio de Salud Publica (MSP), Ministerio del Interior (MI), Ministerio de Vivienda, Ordenamiento Territorial y Medio Ambiente (MVOTMA).

2015 and, as usual in many other countries, VAT represents the largest source of tax revenue in Uruguay, accounting for roughly 50% of the total tax collection.<sup>10</sup> Firms are required to remit VAT payments all along the production and distribution chain.<sup>11</sup> The standard VAT rate is 22%, and a small number of specific products (a basic basket of foodstuff) have a 10% rate or are exempt. Although we study the impact of our experiment on other taxes, our main focus is on the VAT.

Tax morale in Uruguay—the intrinsic motivation to comply with taxation—is believed to be among the highest in Latin America and possibly comparable to some developed nations. For instance, according to survey data from the 2010–2013 wave of the World Values Survey, 77.2% of respondents from Uruguay say that evading taxes is “Never Justifiable,” while this proportion is 68.2% among all other Latin American countries (population-weighted) and 70.9% for the United States. Tax evasion is conversely relatively low in Uruguay. According to estimates from Gomez-Sabaini and Jimenez (2012), evasion of VAT in Uruguay was around 26% in 2008, the third lowest rate among the nine Latin American countries included in the study and roughly comparable to the 22% evasion rate computed for Italy in 2006 (Gomez-Sabaini and Moran, 2014).

### 3.2 Subject Pool and Randomization

Our experiment was conducted in collaboration with the IRS. As of May 2015, there were 120,125 firms registered with the IRS of Uruguay. A subsample of 4,597 firms preselected by the IRS was put aside for the *audit-threat* sample, which we call the secondary experimental sample. Of the remaining firms, we selected a group to form the main experimental sample.

To form this main sample, we excluded some firms by request of the IRS. For instance, we excluded firms subject to special regimes for VAT payments (very small or very large firms). We also kept in the experimental sample only firms that had made VAT payments in at least three different months during the previous 12-month period<sup>12</sup> and those with a total value added of at least USD 1,000 – for the sake of simplicity, all amounts shown in this paper are adjusted by inflation and converted from Uruguayan pesos to U.S. dollars using the nominal

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<sup>10</sup>Own calculations based on data from the Central Bank of Uruguay and from the Internal Revenue Service. The other sources of tax revenues are the personal income tax, the corporate tax, and some specific taxes to consumption, businesses and wealth.

<sup>11</sup>Firms may credit VAT paid on input costs (i.e., imports and purchases from their suppliers) against the total sales of goods and services to their costumers (i.e., “tax debit”). They pay VAT to the IRS only on the excess of the total “tax debit” over the tax credit. If the tax credit exceeds the debit, the excess may be carried over for future tax years. While the VAT should have the same implications than a retail sales tax in theory, in practice they are believed to differ in some substantial aspects (Slemrod, 2008).

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

exchange rate from August 2015.

To maximize the impact of our information provision experiment, we wanted the letters to be delivered to the owners of the firms, or at least to those making the day-to-day decisions. In some cases, owners provide the address of external accountants instead of their own addresses. Since the IRS has data on the addresses of all registered accountants, we dropped all of these cases from the sample. We were also concerned that in very large firms the effect of the information may be substantially diluted since it would probably not reach the owner. For that reason, we excluded firms with a total value added above USD 100,000 during the previous 12 months.

These criteria left us with 20,471 firms for the main experimental sample. All these firms were randomly assigned to receive one of the four letter types, with the following distribution: 62.5% of the firms were assigned to our main treatment arm, the *audit-statistics* letter; the other three letter types (*baseline*, *audit-endogeneity*, and *public-goods*) were each assigned to 12.5% of the sample.<sup>13</sup> After removing the roughly 18.5% of the letters that were returned by the postal agency, the final distribution of letter types was 10,272 to *audit-statistics*; 2,064 to *baseline*, 2,039 to *audit-endogeneity*, and 2,017 to *public-goods* (total N = 16,392).

The 4,597 firms in the secondary sample were assigned to receive the *audit-threat* letter. Half of them were assigned to the 25% audit probability and the other half to the 50% audit probability. After excluding the 12% of letters returned by the postal office, we were left with 2,015 firms in the 25% probability group and 2,033 firms in the 50% probability group (total N = 4,048).

Columns (1) through (4) of Table 1 compare the balance of pretreatment characteristics between firms assigned to the different letter types in the main experimental sample, with characteristics such as VAT paid prior to the experiment, the age of the firm and the number of employees. Additionally, for each characteristic, column (5) presents the p-value of the test of the null hypothesis that the averages are the same across all four letter types. As expected, the differences across letter types are economically but not statistically significant. Columns (6) through (8) of Table 1 present a similar balance test, except for the secondary sample used for the *audit-threat* arm. Again, the characteristics are balanced across firms that received the 25% threat letter and firms that received the 50% threat letter.

Table 2 provides some descriptive statistics for the firms in our experimental sample. Column (2) of Table 2 corresponds to all firms in the main experimental sample. On average, these firms had paid USD 1,890 in VAT over the past three months (implying a value added of about USD 8,600), they had been registered with the IRS for 15.3 years, they had 4.8

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<sup>13</sup>The randomization to letter types was stratified by the quintiles of the distribution of value added over the 12 months previous to the randomization.

employees, 14% of them had been audited at least once over the previous three years, and 22% belonged to the retail sector.

Column (1) of Table 2 corresponds to the universe of registered firms. By design, firms in our experimental sample are smaller, both in terms of number of employees and level of VAT payments. Lastly, column (3) of Table 2 provides statistics about the secondary experimental sample (i.e., for the *audit-threat* treatment arm). While some statistically significant differences exist between firms in the two groups, they are still broadly comparable in size. The main difference between firms in the two samples is that the audit rates were 7 percentage points higher in the *audit-threat* sample. This difference is by design because the IRS selected firms classified as high-risk for this treatment arm, which had been targeted to be audited more frequently in the past.

### 3.3 Econometric Specifications

We want to compare outcomes across treatment arms as well as across subtreatment arms. For the comparison across treatment arms, consider the sample of firms assigned to either baseline letter or one of the other letter types, indexed by  $j$ : *audit-statistics*, *audit-endogeneity* or *public-goods*. The baseline specification is given by the following:

$$Y_i = \alpha + \beta \cdot D_i^j + X_i \delta + \epsilon_i \quad (1)$$

The outcome variable ( $Y_i$ ) is the total outcome during the 12-month posttreatment period (i.e., after the delivery of the treatment letter).  $D_i^j$  is a dummy variable that takes the value 0 if  $i$  was assigned to the *baseline* letter, and the value 1 if  $i$  was assigned to letter type  $j$ . Last,  $X_i$  is a vector of control variables.

In the second econometric model, we use data only for firms assigned to the *audit-statistics* letter and estimate the following regression:

$$Y_i = \alpha + \gamma_p \cdot p_i + \gamma_\theta \cdot \theta_i + X_i \delta + \epsilon_i \quad (2)$$

Where  $p_i \in (0, 1)$  is the audit probability included in the letter sent to individual  $i$ , and  $\theta_i \in (0, 1)$  is the penalty rate included in the letter sent to individual  $i$ . The resulting coefficients can be directly interpreted as elasticities, because the audit probabilities and penalty rates are expressed from 0 to 1 and we use a Poisson regression model. For instance,  $\gamma_p = 1$  would imply that a 1 percentage point increase in the audit probability increases the VAT payments by 1%.

We always include in  $X_i$  a set of four dummies corresponding to the five groups of similar firms from which we drew the sample to calculate  $p_i$  and  $\theta_i$  — this approach ensures that we

are only exploiting variation in  $p_i$  and  $\theta_i$  that is exogenous (i.e., due to sampling variation).

In the third econometric model, we use data only for firms assigned to the *audit-statistics* letter and estimate the following regression:

$$Y_i = \alpha + \gamma_p \cdot p_i + X_i \delta + \epsilon_i \quad (3)$$

Where  $p_i \in \{0.25, 0.50\}$  is the audit probability included in the *audit-threat* letter sent to individual  $i$ .

When outcomes are persistent over time, which applies to the case of VAT payments, the use of pretreatment controls can help reduce the variance of the error term and thus results in gains in statistical power (McKenzie, 2012). Thus, our baseline specification includes the outcomes during each of the previous 12 pretreatment months as control variables ( $X_i$ ).

In our baseline specification, we use a Poisson regression model to allow for proportional effects and bunching at zero, and we present robustness checks with alternative regression models. In the interest of transparency, for each coefficient related to posttreatment effects, we also present a falsification test based on pretreatment “effects”; that is, we re-estimate the model, but instead of using posttreatment outcomes as the dependent variable, we use pretreatment outcomes. We should expect these pretreatment effects to be close to zero and not statistically significant.

### 3.4 Outcomes of Interest

The letters were provided to the Uruguay Postal Office on August 21, 2015. The vast majority of the letters were delivered in the month of September, and therefore we define August as the last month of the pretreatment period and October as the first month of the posttreatment period. The main outcome of interest in our study consists of the total VAT amount remitted by taxpayers in the 12 months subsequent to receiving the letter.<sup>14</sup>

Table 3 presents some descriptive statistics about the distribution of payments for firms that received the *baseline* letter type. On average, the total amount of VAT paid in the 12-month pretreatment period is about USD 7,700, while the amount for the corresponding posttreatment period is approximately USD 6,500. This negative trend in VAT payments can be explained by this sample containing smaller firms, which have a high turnover rate. The size of posttreatment VAT payments varied substantially, ranging from a 10th percentile of USD 400 to a 90th percentile of USD 16,550.

Furthermore, we can break down firms’ VAT payments according to their timing. We can observe the date of the transfer to the IRS as well as the month for which the payment was

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<sup>14</sup>This variable includes VAT payments and also VAT withholding made by third party agents.

intended. Firms can transfer funds to cover their liabilities in previous periods. Since firms typically make VAT payments on a monthly basis, they normally cover the current and the previous month, which we call concurrent payments (73.5% of the firms in July 2015). We classify payments for two or more months in the past as retroactive payments (3.9% of the firms in July 2015).

Finally, although we focus on VAT payments in our analysis, we obtained data from the IRS on the other main taxes paid by the firms, which included corporate income taxes and net worth taxes that represent (with VAT) more than 96% of the total tax burden of firms. We use payments of these taxes as additional outcomes of interest.

### 3.5 Survey Implementation

The IRS, with the support of the Inter-American Center of Tax Administrations and the United Nations, had previously administered a survey on the costs of tax compliance for small and medium-sized businesses. We collaborated with the tax authority in the design and implementation of this survey. The survey included a module specific to our experiment, to capture the degree to which our information provision experiment might have affected recipients' beliefs. The survey included seven additional modules designed by the IRS to assess the taxpayers' burden of reporting in terms of time, money, and patience.

To ensure trustworthy responses, the IRS assured potential respondents that the survey was anonymous and that replies could not be traced back to specific individuals or firms. We partnered with local and international universities to increase respondent confidence and to highlight that the survey was part of a study and part of an audit or compliance campaign by the IRS. Since we were interested in the effect of our experiment on the beliefs elicited by means of the survey, we embedded a code in the emailed survey link to identify which treatment arm of the experiment the recipient was assigned to (i.e., which of the four letter types and, within the *audit-statistics* treatment, which combination of  $p$  and  $\theta$ ). These codes did not uniquely identify any single firm but allowed us to link treatment arms and survey responses while still maintaining the anonymity.

The email invitations to the online survey (see a sample in Appendix A.6) was sent by email on May 2016, about nine months after the letters from our experiments were sent. The IRS communicates mainly by postal mail, and it thus has the mailing addresses of the owners of all registered firms. However, the tax agency only keeps records of email addresses for a subset of firms that used their online services in the past. We sent invitations to all the firms in the main experimental sample with a valid email address.<sup>15</sup> The last column of

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<sup>15</sup>The IRS wanted to target taxpayers and not their agents for this study. We did not include email addresses that in the full sample were repeated more than three times, which most likely correspond to

Table 2 presents the average characteristics among the 3,845 firms that were invited to the survey. The firms invited to the survey were very similar in characteristics to those in the entire experimental sample (shown in column 2).

Our purpose was to elicit the beliefs of firm owners. Since the IRS records could not ensure that the registered email address corresponded to the firms' owners, we asked the survey respondent to self-identify as one of the following five types: owner, internal accountant, external accountant, manager, or other employee. From the 3,845 recipients that we invited to participate in the survey, we received 2,331 responses (response rate of 60.6%). Of these 2,331, 45% self-identified as owner, 4.4% as internal accountant, 5.4% as external accountant, 1.9% as manager, 4.5% as other employee, and the remaining 38.8% did not provide a response to this question. For the baseline results, we use only respondents who self-identified as owners – the results are robust to the inclusion of all respondents (see Appendix C.4).

A noteworthy aspect of the survey was that none of the questions was mandatory by request of the IRS. Among respondents self-identified as owners, the missing data rate for our three key questions is between 19.5% and 23.3%, which is comparable to the average nonresponse rate for all questions in the survey (17.8%).

## 4 Results: Effects of Messages about Audits

### 4.1 Baseline Results

Our baseline results capture the impact of our mailing campaign on our outcomes of interest (subsequent tax payments). These results are obtained by comparing the posttreatment tax payments of firms assigned to the *audit-statistics*, *audit-endogeneity*, and *public-goods* letters with the payments from recipients of the *baseline* letter. We interpret these as the effects of the corresponding messages (*audit-statistics*, *audit-endogeneity*, and *public-goods*).

Figure 2 summarizes these baseline results. In each of the three panels, we plot the difference between the VAT payments of the firms assigned to the *baseline* letter to the payments of firms assigned to each of the other three treatment arms for the two quarters preceding our mailing campaign and for the four subsequent quarters.<sup>16</sup> The effects of each of the treatment arms are computed by means of Poisson regressions, so that the coefficients can be directly interpreted as semi-elasticities. These regressions are simple, with no additional control variables.

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accountants.

<sup>16</sup>We top-coded all outcomes of interest at 99.99% to avoid the contamination of the results by typos and outliers.

Figure 2.a shows that the *audit-statistics* message had statistically and economically significant effects on VAT payments. For instance, the point coefficient corresponding to the third posttreatment quarter implies that the *audit-statistics* message increased the VAT payments by 8.7% ( $p = 0.012$ ). The effects are similar in magnitude for all the posttreatment quarters (7.8% in the first quarter, and about 5.6% in the second and fourth quarters after treatment), suggesting that this effect was stable and persistent. The coefficients on the pretreatment VAT payments correspond to a falsification test for our experiment. As expected by the random assignment of firms to different treatment arms, the pretreatment differences in VAT payments are economically small and not statistically significant (effects of less than 1% and about  $-1.7\%$ , with  $p$ -values greater than 0.6 in both cases).

Figure 2.b shows that the *audit-endogeneity* treatment arm also induced a significant change in VAT payments compared to the *baseline* letter. The effect of adding the *audit-endogeneity* message is positive and statistically significant in all four posttreatment quarters, and ranges between 10% and 12.4%. These effects are slightly higher than those of the *audit-statistics* treatment arm, but these differences are not statistically significant at standard levels. The differences for the two pretreatment quarters are also economically small and statistically nonsignificant for the *audit-endogeneity* treatment arm.

Figure 2.c, in turn, depicts the effects of the *public-goods* treatment arm. Adding this message to the *baseline* letter did not seem to have an effect as high and stable as that of the other two treatment arms. While there are large posttreatment differences in posttreatment VAT payments, ranging from 5.0% to 10.1% (significant at standard levels in the second and third quarters), inspection of the event-study reveals substantial differences in the pretreatment period between firms assigned to the *public-goods* letters and those assigned to the *baseline* letter. A proper assessment of the effect of the *public-goods* message requires us to control for these differences in pretreatment outcomes, which we do in the regression analysis that follows.

Table 4 presents the baseline regression results. These estimates are obtained by means of Poisson regressions—the results are qualitatively and quantitatively similar to those from alternative estimators.<sup>17</sup> In Table 4, we control for pretreatment outcomes as described in Section 3.3. The first column presents the results of our baseline results: the effects of each of the three treatments (*audit-statistics* in Panel A, *audit-endogeneity* in Panel B, and *public-goods* in Panel C) compared with the outcomes for firms that received the *baseline* letter. The posttreatment coefficients correspond to regressions with total VAT paid in the 12 months after the delivery of the letter as the dependent variable. Additionally, we also include a series of placebo tests: the pretreatment coefficients correspond to regressions with

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<sup>17</sup>These additional results are presented in Appendix C.1.

total VAT paid in the 12 months prior the delivery of the letter as the dependent variable.

The first column from Table 4 corresponds to average effects of each treatment arm for the entire sample. The posttreatment coefficient of *audit-statistics* (panel a.) indicates that firms receiving the *audit-statistics* message paid 6.3% more VAT in the 12 months after the intervention on average. This effect is not only highly statistically significant ( $p = 0.013$ ), it is also economically substantial. Using the estimated average evasion rate of 26% from Gomez-Sabaini and Jimenez (2012), the effect amounts to a reduction in the evasion rate of 24% ( $= \frac{6.3\%}{26\%}$ ). The (placebo) effect on pretreatment outcomes is close to zero ( $-0.8\%$ ), not statistically significant at standard levels, and even more precisely estimated than the corresponding posttreatment effect (the standard error on the pretreatment coefficient is 0.021, 16% smaller than the corresponding 0.025 for the posttreatment coefficient).

The effects of our *audit-statistics* treatment are not directly comparable to those of the audit message from Pomeranz (2015) because the messages differed in content and because the two studies cover firms from different countries and with different characteristics. Nevertheless, Table 4 from Pomeranz (2015) indicates that the deterrence letter in that study led to an increase in VAT payments of 7.6%, which is similar in magnitude and statistically indistinguishable from the 6.3% effect of our *audit-statistics* message.

Panel b. from Table 4 indicates that the *audit-endogeneity* message increased subsequent VAT payments by 7.4% ( $p = 0.021$ ), with the placebo experiment confirming the pretreatment balance in the outcome of interest. This effect is similar in magnitude to the 6.3% effect of our *audit-statistics* message (difference not statistically significant). In other words, the addition of either of the two messages about audits had a similar effect on VAT payments.

Finally, there is weaker evidence that the *public-goods* message affected VAT payments. Panel c from Table 4 indicates that the *public-goods* message had an effect on subsequent VAT payments of 4.3%, which was not statistically significant at standard levels ( $p = 0.147$ ); this effect is smaller than the effect for the other two treatment arms. These results control for pretreatment outcomes, which explains the differing pattern of statistical significance with respect to the coefficients in Figure 2.c.

The results discussed so far correspond to the average effect of each treatment arm. The literature on tax evasion and the results from previous empirical studies indicate that there could be some heterogeneity in the effect of our treatments on evasion behavior. Columns (2) to (5) of Table 4 present the analysis of heterogeneity in our treatments' effects along two dimensions: firms above or below median size (columns 2 and 3) and firms that have and have not been audited in the recent past (columns 4 and 5).

The results in columns (2) and (3) of Table 4 indicate that the effects of the *audit-statistics* and *audit-endogeneity* messages were more prominent among larger firms: the coefficients

are larger and statistically significant for firms above median size compared with those below median size—8.8% and 7.1% compared with 4.3% and 3.5% for *audit-statistics* and *audit-endogeneity*, respectively. However, we must take this difference with a grain of salt because it is not statistically significant at standard levels. In turn, there is no discernible difference in effect sizes for the *public-goods* treatment arm.

The results in columns (4) and (5) of Table 4, indicate in turn that the effects of the *audit-statistics* and *audit-endogeneity* treatment arms were mainly driven by firms that had not been audited in the recent past. However, again we lack statistical power to establish this result unequivocally. This pattern is consistent with recently audited firms being more aware (or more frightened) of the possibility of being subject to an inspection by the IRS.

## 4.2 Effects by Type and Timing of Tax Payments

As previously described, firms in Uruguay can make payments for their present liabilities, but they can also pay taxes for previous periods—either because they owe past taxes or because they are revising their accounts and correcting past mistakes or imputing invoices they did not have at the time of the original payment.

When firms that engage in tax evasion have increased fear of being audited, we can expect them to increase their tax payments (reduce their evasion) in the future, but we can also expect them to retroactively revise their payments for previous time periods to reduce or eliminate their past evasion. We explore this possibility with the results presented in the first two columns of Table 5, which split the effects of our treatment arms on concurrent and retroactive payments. For reference, we include in column (3) the baseline results on total VAT payments (those from column 1 in Table 4).

Consistent with increased fear of being audited, the messages about audits had an economically and statistically significant effect on retroactive payments. Indeed, because of the much lower baseline rate, the effects on retroactive payments are larger in magnitude than the effects on the concurrent payments. For instance, the effect for *audit-statistics* message is 38.1% ( $p = 0.004$ ) for the retroactive payments and 4.4% ( $p = 0.087$ ) for the concurrent payments. The results are similar for the *audit-endogeneity* message (effects of 31.4% and 6.1%, respectively). In contrast, the *public-goods* message does not have a statistically significant effect either on retroactive payments or on current payments ( $p = 0.146$  and  $p = 0.304$ , respectively).

We have so far established that firms in two of our three treatment arms increased their VAT payments compared to recipients of the *baseline* letter. Our analysis focuses on VAT because VAT liabilities represent the largest fraction of tax payments by firms in our sample

and because VAT is the tax that leaves more room for exploiting loopholes and the lack of third-party reporting. However, our mailing referred to taxes in general and did not mention VAT or any other specific tax. In fact, the effects on VAT may not represent a net increase in tax payments; firms may increase their evasion (i.e., reduce their payments) of other taxes they are liable for.

The results in columns (4) through (6) of Table 5 help us deal with these considerations. The columns present the effects of our treatment arms for different taxes: VAT, other taxes (mostly the corporate income tax), and total (i.e., VAT + other). The evidence suggests that, far from crowding out other tax payments, the *audit-statistics* and *audit-endogeneity* messages had positive effect on non-VAT revenues. Indeed, the effects on payments of other taxes are as economically and statistically as significant as those on VAT payments. The *audit-statistics* had an effect of 6.3% on VAT payments, while the effect on other tax payments was 7.7%. ( $p = 0.038$ ). This difference implies that the effect of the *audit-statistics* message on other tax payments was 22.2% larger compared with VAT payments. The results are similar for the *audit-endogeneity* message (effects of 7.4% and 8.4%, respectively). In contrast, the effect of the *public-goods* message on other tax payments is close to zero (0.1%) and not statistically significant at standard levels. The effect of the *public-goods* message on total tax payments was also small (1.8%) and statistically insignificant.

## 5 Results: Causal Mechanisms

### 5.1 Evidence from the *Audit-Statistics* and *Audit-Threat* Sub-Treatments

The results in the previous section indicate that our *audit-statistics* and *audit-endogeneity* messages had significant and substantial effects on VAT payments. This evidence, however, does not allow us to establish the precise channels through which the information we provided in our mailings affected tax payments and evasion behavior. In this section, we present further evidence in an attempt to distinguish between the rational and the fear channels; that is, whether firms re-optimized their evasion decisions based on the information we provided, or if they just reacted out of some irrational fear after being exposed to information about tax audits.

According to the Allingham and Sandmo (1972) model, the VAT payments should increase in both audit probabilities and penalty rates. We calibrated this model to obtain some quantitative predictions as a benchmark for what we could expect from our information treatments (see the details of this calibration and the results from alternative assumptions

in Appendix B). Our preferred model assumes that individuals derive a “warm glow” effect from paying their taxes, so that we can fit the data without relying on an extreme curvature of the utility function. This model predicts a behavioral elasticity of tax payments with respect to the audit probability of 4.02 and an elasticity of tax payments with respect to the penalty rates of 1.64.

Instead of comparing the behavior of firms in different treatment arms with that of firms in the *baseline* group, the results in this section are based on a comparison of the behavior of firms within the main treatment arm, *audit-statistics*. We measure the effect of the signals about audit probabilities and penalty rates on their posttreatment payments. The resulting coefficients can be directly interpreted as elasticities. For instance, a coefficient on the audit probability with a value of 1 would imply that a 1 percentage point increase in the audit probability increases the VAT payments by 1%. Similarly, a coefficient on the penalty rate with a value of 1 would imply that a 1 percentage point increase in the penalty rates would increase VAT payments by 1%.

Table 6.a presents estimates of these elasticities for the firms in the *audit-statistics* sub-treatments.<sup>18</sup> The estimates are close to zero and not statistically significant. The elasticity with respect to the audit probability is 0.030 (with a standard error [se] of 0.236,  $p = 0.897$ ), and the elasticity with respect to the penalty rate is  $-0.118$  (se 0.115,  $p = 0.304$ ). In other words, within the group of firms that received the *audit-statistics* message, those who received signals of higher audit probabilities and penalty rates did not significantly increase their VAT payments compared with firms in the same group that received signals with lower values of audit probabilities and penalty rates.<sup>19</sup> Table 6.a also presents estimates for pretreatment outcomes, for firms above or below median size, and for those who had and had not been audited in the recent past. In all cases, the estimates are not statistically significant, suggesting that these null results are not driven by differences in the evolution of pretreatment outcomes.<sup>20</sup>

Since we devoted a large fraction of our subject pool to this treatment arm, these elasticities are quite precisely estimated. We can reject the null hypothesis that each of these elasticities is equal to those predicted by the calibrated model (4.02 for the audit probability and 1.64 for the penalty rate). Furthermore, we can rule out even smaller effects; the 90%

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<sup>18</sup>Table C.2 in the Appendix presents the results from alternative specifications based on OLS, Tobit and Probit models.

<sup>19</sup>The results are robust if, instead of estimating the elasticities w.r.t.  $p$  and  $\theta$  separately, we estimate the elasticity w.r.t.  $p * \theta$

<sup>20</sup>For completeness, Table C.3 in the Appendix presents the results for the *audit-statistics* elasticities with the same breakdown as in Table 5, i.e., for retroactive and concurrent VAT payments, and for VAT versus other taxes. The pattern of results in that table is consistent with these results: firms did not seem to react to the different messages about probability of audits and penalty rates included in the letters.

confidence interval for the audit probability excludes elasticities above 0.418, and the 90% confidence interval for the penalty rate excludes elasticities above 0.071.

As complementary evidence, we can use the results from the *audit-threat* secondary sample, which generated alternative variation in the audit probabilities by randomly assigning firms to messages of audit probabilities of 25% and 50%. Table 6.b presents the results of this treatment arm. As in the *audit-statistics* treatment, the coefficient from the Poisson regression can be interpreted directly as the behavioral elasticity. The *audit-threat* messages implies an elasticity of 0.376 and borderline significant at the 10% level ( $p = 0.073$ ).<sup>21</sup> The estimated elasticity for the *audit-threat* message is thus somewhat larger than the one found for the *audit-statistics* message (0.03). However, this elasticity of 0.376 is still economically small, and it is statistically different from the elasticity of 4.02 predicted by our calibration of Allingham and Sandmo (1972).

We can also explore whether the elasticities are larger for a particular range of  $\{p, \theta\}$ . Figure 3.a estimates the effects of the *audit-statistics* and *audit-threat* subtreatments in a less parametric way, by breaking down the effect of the *audit-statistics* message by decile of  $p$  (left panel) and by decile of  $\theta$  (right panel). There does not seem to be a systematic relationship between the effect of the *audit-statistics* message and the values of  $\{p, \theta\}$  contained in the message.

Figure 3.b provides an event-study analysis of the effect of the *audit-statistics* message (relative to the *baseline* letter), split into two groups: firms that received above- and below-median signals of  $p$ . Figure 3.c presents the equivalent analysis for firms that received above- and below-median values of  $\theta$ . And Figure 3.d provides the equivalent analysis for the *audit-threat* arm, comparing firms assigned to the 25% and 50% conditions. Consistent with the previous evidence, Figure 3.b-d suggest that the effects of the messages are unrelated to the levels of  $p$  and  $\theta$ .

All in all, these results indicate that firms did not seem to react to the different messages about probability of audits and penalty rates included in the *audits-statistics* letters. Our favorite interpretation is that the effects of the *audit-statistics* message was due to the fear channel rather than due to rational re-optimization.

## 5.2 Evidence from the Survey Data

In this section, we distinguish between the rational and the fear channels by measuring the effects of the *audit-statistics* and *audit-endogeneity* messages on beliefs, as captured by means

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<sup>21</sup>However, the pre-treatment (falsification) coefficient (-0.342) is also borderline statistically significant at the 10% level ( $p$ -value=0.055), indicating that the post-treatment coefficient may be spurious.

of the survey we carried out nine months after the delivery of the letters.

Figure 4.a and 4.b depict the distributions of perceptions about audit probabilities and penalty rates, respectively, as elicited from the survey. The shaded bars show the distribution of perceptions for individuals who received the *baseline* letter. The red curves correspond to the distribution of signals sent to the firms in the *audit-statistics* letters.

The comparison between the shaded bars and the red curve from Figure 4.a suggests that respondents substantially overestimated the probability of being audited on average. While our statistics indicate a probability of roughly 11.7%, the mean perception in the *baseline* group is 37.6% ( $p < 0.01$  for the difference). Conversely, the comparison between the shaded bars and the red curve from Figure 4.b suggests that respondents were about right regarding the penalty rates on average; the average penalty is 30.7%, while the mean of the perceived penalty is 31.0% in the *baseline* group.

A potential explanation for the positive bias in the perceived audit probability is given by the availability heuristic bias (Kahneman and Tversky 1974). According to that model, individuals judge the probability of an event by how easily they recall instances of the event. Even though audits are rare, the fact that they are visible among colleagues and even sometimes salient in the media may induce firms to assign a high probability. Indeed, there is evidence that individuals overestimate the probabilities of a wide range of rare events of a similar nature (Lichtenstein et al., 1978; Kahneman, Slovic, and Tversky, 1982).

Regarding the distribution of beliefs, the systematic bias in the perceptions of audit probabilities and penalty rates in the *baseline* group presents evidence against the rational mechanisms and in favor of the fear mechanism; that is, if the *audit-statistics* information eliminated some of this systematic bias, it would lower the perceived audit probability and thus decrease rather than increase tax compliance.

To test this hypothesis more directly, the shallow bars in Figure 4 depict the distribution of perceptions for respondents from firms in the *audit-statistics* treatment arm compared to different control subsamples, whereas Table 7 presents the average of these perceptions and their differences between groups. Inspection of Figure 4.a indicates that, if anything, the *audit-statistics* message slightly reduced the perceived probability of being audited, from an average of 37.6% to an average of 35.4%. Although this difference is not statistically significant, the difference becomes significant once we increase the statistical power by pooling subjects from the *baseline* and the *public-goods* groups (Figure 4.c and Table 7) since both received messages with no specific information about audit probabilities.

As indicated by Table 7, our information treatment seems to have reduced the perception of the probability of audits from an average of 40.7% for the pooled group to 35.4% for respondents from firms in the *audits-statistics* treatment arm ( $p = 0.033$  for the difference).

Moreover, each panel in Figure 4 reports the results from an Epps–Singleton two-sample test using the empirical characteristic function, which is a version of the Kolmogorov–Smirnov test of equality of distributions that is valid for discrete data (Goerg and Kaiser, 2009). According to this test, the *audit-statistics* message did not have a statistically significant effect on the distribution of perceptions about audit probabilities (p-values of 0.25) compared with the distribution for the *baseline* group only (Figures 4.a), but when we increase statistical power by adding the *public-goods* respondents to the control group the difference between the two distributions is statistically significant at the 5% level (Figure 4.c).<sup>22</sup>

Meanwhile, the two distributions of perceived penalty rates are statistically indistinguishable with *baseline* only or with the additional observations in the control group (p-values of 0.15 and 0.5, Figures 4.b and 4.d) The *audit-statistics* message had a very small effect on the perceived penalty rate, decreasing it from an average of 32.2% to an average of 29.9% for the *baseline* only control group, and from 30.42% to 29.9% with the pooled control group (Table 7). These differences are not statistically significant at standard levels.

To sum up, the *audit-statistics* treatment arm seems to have reduced the average perceived audit probability, and it did not affect the average perceived penalty rate. The rational mechanism would suggest that the *audit-statistics* message should have reduced VAT payments since it reduced the perceived probability of tax audits among recipients. This prediction, however, is at odds with the observed positive effect of the *audit-statistics* message discussed in Section 4.1. Our favorite interpretation is that firms reacted with some form of irrational fear from our mailing, rather than learning and re-optimizing their behavior in the rational way predicted by the Allingham and Sandmo (1972) model.<sup>23</sup>

## 6 Conclusions

Economists often posit that firms incorporate the threat of being audited into their tax evasion decisions. However, no consensus exists as to whether they proceed in a rational optimizing way as suggested by the model of Allingham and Sandmo (1972). We conducted a large-scale field experiment with firms that collectively pay over USD 200 million dollars in taxes per year, and we measured the effect of our information treatments on behavior (tax payments obtained from administrative data) and on beliefs (obtained from a survey of

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<sup>22</sup>The *public-goods* letter did not include any information about audit probabilities or penalty rates, and they can thus be considered valid controls to assess if the information in the *audits-statistics* letters had an effect on recipients’ beliefs. We include them alongside the *baseline* letters to increase the statistical power of the test.

<sup>23</sup>Appendix C.3 presents suggestive evidence that the effect of the *audit-endogeneity* message is also due to fear, because recipients were already aware of the endogeneity of audit probabilities.

recipients).

We show that, consistent with prior findings, providing information related to audits increases firms' tax payments. However, we showed that individuals did not react to the different signals about audit probabilities and penalty rates included in the message. Also, the information treatments reduced the perceived probability of tax audits, which should have triggered an increase in tax evasion, yet we find that our letters actually increased tax payments. Our favorite interpretation of these findings is that the messages about audits affects tax evasion decisions primarily through creating a sense of fear, rather than by making the taxpayers revise their beliefs about audits and subsequently re-optimize their behavior.

Our findings contribute to the debate about the determinants of tax compliance. Although the failure of the Allingham and Sandmo (1972) model to predict evasion rates may be interpreted as an indication that tax compliance depends on factors such as tax morale (Luttmer and Singhal, 2014) rather than on tax enforcement, our evidence suggests that tax enforcement indeed matters, but in a context of optimization and information frictions.

Our findings provide some insights for tax collection. Holding the actual detection rate fixed, tax revenues may be higher if audits and other detection mechanisms are made more salient to the taxpayers.<sup>24</sup> Indeed, there is evidence that some tax agencies are already taking advantage of this approach. For instance, Blank and Levin (2010) find a disproportionately large number of tax enforcement press releases during the weeks immediately prior to Tax Day, presumably in order to influence taxpayers' perceptions while they are preparing to file their annual tax returns.

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<sup>24</sup>For a practical discussion on how to implement this type of policy, see for example Morse (2009). Furthermore, salience can be used to improve compliance with other laws: for instance, Dur and Vollaard (2016) show experimental evidence that the use of a salience intervention can significantly reduce illegal garbage disposal.

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Table 1: Balance of Observable Firm Characteristics across Treatment Groups

	Main Sample					Secondary Sample		
	Audit Statistics (1)	Public Goods (2)	Audit Endogeneity (3)	Baseline (4)	p-value test (5)	Audit Threat (25%) (6)	Audit Threat (50%) (7)	p-value test (8)
% paid VAT taxes (3 months pre-mailing)	0.92 (0.00)	0.94 (0.01)	0.93 (0.01)	0.93 (0.01)	0.18	0.90 (0.01)	0.89 (0.01)	0.54
Amount of VAT paid (3 months pre-mailing)	1.87 (0.03)	1.96 (0.07)	1.93 (0.07)	1.91 (0.06)	0.56	1.74 (0.10)	1.75 (0.09)	0.95
Years registered in tax agency	15.34 (0.17)	14.75 (0.22)	15.70 (0.54)	15.01 (0.22)	0.27	19.45 (0.28)	19.42 (0.29)	0.94
% audited between 2011-2015	0.14 (0.00)	0.14 (0.01)	0.12 (0.01)	0.14 (0.01)	0.17	0.21 (0.01)	0.20 (0.01)	0.69
Number of employees	4.81 (0.26)	4.66 (0.54)	4.88 (0.57)	5.09 (0.64)	0.96	4.83 (0.13)	4.88 (0.12)	0.80
% retail trade sector	0.22 (0.00)	0.22 (0.01)	0.21 (0.01)	0.23 (0.01)	0.78	0.33 (0.01)	0.32 (0.01)	0.40
% Agricultural, forest and others	0.03 (0.00)	0.03 (0.00)	0.03 (0.00)	0.03 (0.00)	0.77	0.03 (0.00)	0.04 (0.00)	0.12
% construction sector	0.03 (0.00)	0.03 (0.00)	0.03 (0.00)	0.03 (0.00)	0.85	0.03 (0.00)	0.03 (0.00)	0.33
% other sector	0.73 (0.00)	0.73 (0.01)	0.73 (0.01)	0.72 (0.01)	0.95	0.61 (0.01)	0.62 (0.01)	0.54
Observations	10,272	2,017	2,039	2,064		2,015	2,033	

Notes: Averages for different pre-treatment firm-level characteristics, by treatment group and type of sample. The main sample includes all firms selected as described in section 3.2. The secondary sample includes high risk firms selected by the IRS. Standard errors in parentheses. The last column of each sample reports the p-value of a test in which the null hypothesis is that the mean is equal for all the treatment groups. Data on VAT amount and firm characteristics comes from administrative tax records (including monthly ayments, annual tax returns and auditing registers).

Table 2: Comparison of Firm Characteristics for All Firms, for Firms in Main Sample, for Firms in the Secondary Sample and for Firms Invited to the Survey

	Experimental Sample			
	All firms (1)	Main (2)	Secondary (3)	Invited to the survey (4)
% paid VAT taxes (3 months pre-mailing)	0.78 (0.42)	0.93 (0.26)	0.89 (0.31)	0.93 (0.26)
Amount of VAT paid (3 months pre-mailing)	3.72 (11.55)	1.89 (2.83)	1.74 (4.25)	1.89 (2.98)
Years registered in tax agency	14.21 (14.85)	15.26 (17.16)	19.44 (12.84)	14.46 (10.08)
% audited between 2011-2015	0.08 (0.28)	0.14 (0.34)	0.21 (0.40)	0.11 (0.31)
Number of employees	12.65 (302.98)	4.84 (26.60)	4.89 (5.76)	6.43 (53.77)
% retail trade sector	0.13 (0.34)	0.22 (0.41)	0.33 (0.47)	0.15 (0.36)
% Agricultural, forest and others	0.03 (0.17)	0.03 (0.17)	0.03 (0.18)	0.02 (0.15)
% construction sector	0.03 (0.17)	0.03 (0.17)	0.03 (0.17)	0.03 (0.18)
% other sector	0.84 (0.37)	0.73 (0.45)	0.61 (0.49)	0.80 (0.40)
N	120,125	16,392	4,048	3,845

Notes: Column (1) includes all firms that remitted at least one payment in 2014 or 2015. Column (2) includes the subset of firms selected for the experimental sample according to the criteria described in section 3.2, restricted to firms between USD 1,000 and USD 100,000 of added value. We also exclude firms that were tagged by the IRS as accountancy firms and those that did not report receiving the letter. Column (3) represents a group of high risk firms that were selected from a special sample defined by the IRS and received the *audit-threat* letter. Column (4) corresponds to firms with valid e-mail addresses on file with the IRS, and therefore selected to participate in the on-line survey conducted after the experiment. All data is based on administrative tax records (monthly payments, annual tax returns and auditing registers).

Table 3: Pre-Treatment Tax Payments: Summary Statistics

	Mean (1)	SD (2)	10th (3)	25th (4)	50th (5)	75th (6)	90th (7)
VAT Amounts							
Post-treatment	6.47	7.77	0.44	1.30	3.74	8.48	16.55
Pre-Treatment	7.77	8.07	0.96	1.99	4.86	10.94	19.73
Retroactive VAT Amounts							
Post-treatment	0.30	1.40	0.00	0.00	0.00	0.00	0.62
Pre-Treatment	0.40	1.76	0.00	0.00	0.00	0.00	0.81
Other Taxes Amounts							
Post-Treatment	3.30	5.43	0.00	0.95	1.81	3.52	7.42
Pre-Treatment	4.07	8.57	0.04	1.43	2.14	4.37	8.72

Notes: The statistics in this table correspond to firms that received the *baseline* letter (N=2,064). The pre-treatment period ranges from September 1, 2014 to August 31, 2015 and the post-treatment period ranges from October 1, 2015 to September 30, 2016. Data on payments comes from administrative data records. VAT amounts corresponds to VAT payments and withholdings. Retroactive VAT amount corresponds to two months or more retroactive VAT payments and withholding, e.g. VAT payments made in March 2016 corresponding to September 2015. Other taxes includes payments for the corporate tax, the wealth tax and other specific taxes to bussiness activity.

Table 4: Average Effects of *Audit-Statistics*, *Audit-Endogeneity* and *Public-Goods* Messages

	All (1)	Above Median Size		Recently Audited	
		Yes (2)	No (3)	Yes (4)	No (5)
<b>a. Audit - Statistics vs Baseline</b>					
Post-Treatment	0.063** (0.025)	0.088*** (0.031)	0.043 (0.036)	-0.002 (0.056)	0.068** (0.027)
Pre-Treatment	-0.008 (0.021)	-0.012 (0.023)	0.028 (0.037)	-0.025 (0.054)	-0.003 (0.023)
Observations	12,336	6,211	6,125	1,371	10,965
<b>b. Audit - Endogeneity vs Baseline</b>					
Post-Treatment	0.074** (0.032)	0.071* (0.039)	0.035 (0.042)	0.055 (0.091)	0.075** (0.034)
Pre-Treatment	-0.006 (0.027)	-0.014 (0.031)	0.032 (0.040)	-0.024 (0.070)	-0.005 (0.028)
Observations	4,103	2,052	2,051	425	3,678
<b>c. Public - Goods vs Baseline</b>					
Post-Treatment	0.043 (0.030)	0.045 (0.036)	0.038 (0.043)	0.138* (0.074)	0.025 (0.032)
Pre-Treatment	-0.004 (0.026)	-0.010 (0.029)	0.057 (0.041)	-0.060 (0.063)	0.002 (0.028)
Observations	4,081	2,054	2,027	449	3,632

Notes: \* significant at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. Robust standard errors. The results are based on a Poisson regression, so coefficients can be interpreted directly as semi-elasticities. Panel a. compares the *audit-statistics* message with the baseline letter, while panels b. and c. replicate the analysis for *audit-endogeneity* and *public-goods* messages. In the first row of each panel the dependent variable is the amount of VAT payments (in dollars) after receiving the letter. The second row presents a falsification test in which we estimate the same regression, but using the amount contributed before receiving the mailing (pre-treatment) as the dependent variable. All regressions are estimated with a set of monthly controls that correspond to the year before the outcome, i.e. in the post treatment outcome we include monthly VAT payment controls from September, 2014 to August, 2015 and in pre-treatment outcome we include the same variables for the September, 2013 - August 2014 period. We also restrict the analysis to firms that effectively received the letter as reported by the postal service. Column (1) presents the results for the total number of firms that received each letter. Column (2) presents the effect of each letter on firms with a number of employees greater than the median. Column (3) replicates the estimates for firms with a number of employees below the median. Column (4) presents estimates for firms that were audited at least once between 2012 and 2014, and Column (5) presents the estimates for the group of firms that were not audited in the same period.

Table 5: Average Effects of *Audit-Statistics*, *Audit-Endogeneity* and *Public-Goods* Messages: VAT Payment Timing and Other Taxes

	VAT, By Payment Timing			VAT vs. Other Taxes		
	Retroactive (1)	Concurrent (2)	Retroactive + Concurrent (3)	VAT (4)	Other (5)	VAT + Other (6)
<b>a. Audit - Statistics (N= 10,272) vs Baseline (N= 2,064)</b>						
Post-Treatment	0.381*** (0.131)	0.044* (0.026)	0.063** (0.025)	0.063** (0.025)	0.077** (0.037)	0.052** (0.026)
Pre-Treatment	-0.132 (0.105)	-0.005 (0.022)	-0.008 (0.021)	-0.008 (0.021)	0.016 (0.045)	0.037 (0.026)
<b>b. Audit - Endogeneity (N= 2,039) vs Baseline (N= 2,064)</b>						
Post-Treatment	0.314** (0.139)	0.061* (0.033)	0.074** (0.032)	0.074** (0.032)	0.084** (0.041)	0.079*** (0.031)
Pre-Treatment	0.008 (0.125)	-0.003 (0.027)	-0.006 (0.027)	-0.006 (0.027)	0.006 (0.056)	0.027 (0.031)
<b>c. Public - Goods (N= 2,017) vs Baseline (N= 2,064)</b>						
Post-Treatment	0.195 (0.134)	0.032 (0.031)	0.043 (0.030)	0.043 (0.030)	0.001 (0.048)	0.018 (0.029)
Pre-Treatment	-0.192 (0.124)	0.002 (0.026)	-0.004 (0.026)	-0.004 (0.026)	-0.047 (0.046)	-0.004 (0.027)

Notes: \* significant at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. Robust standard errors. The results are based on a Poisson regression, so coefficients can be interpreted directly as semi-elasticities. Panel a. compares the *audit-statistics* message with the *baseline* letter while panels b. and c. replicate the analysis for *audit-endogeneity* and *public-goods* messages. In the first row of each panel, the dependent variable is the amount of VAT payments (in dollars) after receiving the letter. The second row presents a falsification test in which we estimate the same regression but using the amount contributed before receiving the mailing (pre-treatment) as the dependent variable. All regressions are estimated with a set of monthly controls that correspond to the year before the outcome, i.e. in the post treatment outcome we include monthly VAT payment controls from September, 2014 to August, 2015 and in pre-treatment outcome we include the same variables for the September, 2013 - August 2014 period. We also restrict the analysis to those firms that effectively received the letter. Columns (1), (2) and (3) show the effect of treatment by type of payments. Columns (1) and (2) present separately the effect of treatment on current and retroactive VAT payments, while column (3) presents the overall effect. Columns (4), (5) and (6) present the results by type of tax. Column (4) presents the effect of the treatment in post experiment VAT payments, column (5) presents the effect on the rest of taxes considered, and column (6) presents the effect on the total amount of taxes paid by the firms.

Table 6: Elasticities of Evasion with Respect to Audit Probability and Penalty Rate, *Audit-Statistics* and *Audit-Threat* Sub-Treatments

	All (1)	Above Median Size		Recently Audited	
		Yes (2)	No (3)	Yes (4)	No (5)
<b>a. Audit - Statistics Letters</b>					
Audit Probability (%)					
Post-Treatment	0.030 (0.236)	-0.001 (0.313)	0.012 (0.298)	0.574 (0.446)	-0.005 (0.272)
Pre-Treatment	0.025 (0.115)	0.118 (0.140)	-0.166 (0.200)	-0.211 (0.319)	-0.211 (0.319)
Penalty Size (%)					
Post-Treatment	-0.118 (0.115)	0.005 (0.140)	-0.069 (0.151)	0.066 (0.220)	-0.128 (0.123)
Pre-Treatment	-0.001 (0.088)	-0.005 (0.073)	-0.006 (0.232)	0.160 (0.170)	-0.020 (0.097)
Observations	10,272	5,147	5,125	1,139	9,133
<b>b. Audit - Threat Letters</b>					
Audit Probability(%)					
Post-Treatment	0.376* (0.210)	0.192 (0.245)	0.435* (0.264)	-0.124 (0.340)	0.591** (0.233)
Pre-Treatment	-0.342* (0.178)	-0.320 (0.197)	-0.372 (0.275)	-0.370 (0.299)	-0.177 (0.200)
Observations	4,048	1,844	1,833	653	3,395

Notes: \* significant at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. Robust standard errors Panel a. presents the effect of providing different information regarding  $p$  and in the *audit-statistics* message. Panel b. compares the two *audit-threat* messages, i.e. the 50% threat of audit vs. the 25% threat of audit. Rows (1) and (3) of panel a. present the effect of informing an additional percentage point of  $p$  and  $\theta$  respectively on the post-treatment VAT payments. Rows (2) and (4) present a falsification test in which we estimate the same regression using pre-treatment information as the dependent variable. All regressions are estimated with a set of monthly controls that correspond to the year before the outcome, i.e. in the post-treatment outcome we include monthly VAT payment controls from September, 2014 to August, 2015 and in the pre-treatment outcome we include the same variables for the September, 2013 - August 2014 period. We also restrict the analysis to firms that effectively received the letter as reported by the postal service. Row (1) in panel b. presents the post-treatment effect of receiving the letter of 50% threat relative to receiving the 25% threat letter. These coefficients can be interpreted directly as elasticities. Row (2) of panel b. replicates the estimates for the pre-treatment outcomes. Column (1) presents the result for the total number of firms that received each letter. Column (2) presents the effect of each letter on firms with a number of employees greater than the median. Column (3) replicates the estimates for firms with a number of employees below the median. Column (4) presents estimates for firms that were audited at least once between 2012 and 2014 and Column (5) presents the estimates for the group of firms that were not audited in the same period.

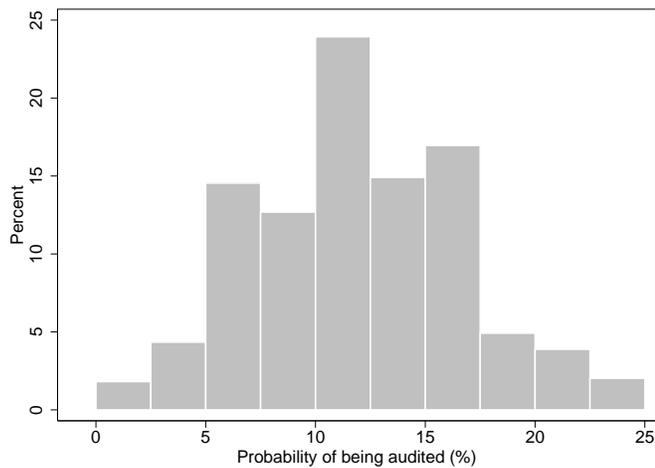
Table 7: Effects of *Audit-Statistics* on Survey Beliefs

	Baseline (1)	Audit Statistics (2)	p-value (3)
<b>Panel a.</b>			
p - Mean	37.65 (3.39)	35.23 (1.32)	0.474
$\theta$ - Mean	32.13 (3.41)	29.90 (1.57)	0.560
<b>Panel b.</b>			
	Baseline + Public Goods	Audit Statistics	p-value
p - Mean	40.73 (2.30)	35.23 (1.32)	0.033
$\theta$ - Mean	30.46 (2.44)	29.90 (1.57)	0.849

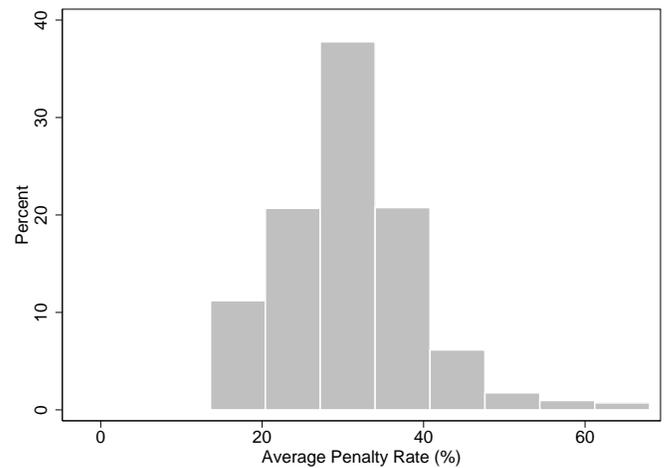
Notes: Table 7 is based on responses given by owners or respondents with missing values in the question regarding who answered the survey. In panel a., Column (1) (N=69) refers to respondents who received the *baseline letter* during the experimental stage. Column (2): “Aud. Statistics / Endogeneity” (N=365 for Aud. Statistics and N=79 for Endogeneity) refers to respondents who received the *audit-statistics* letter (columns 1 and 2), and in row (3) we present results for the group of taxpayers that received the *audit-endogeneity* letter. Column (3) presents the p-value of a test that compares the mean *baseline* and *audit-statistics* perceptions for questions regarding  $p$ (Q2-row (1)),  $\theta$  (Q4-row (2)) and *baseline*, with the endogeneity perception for (Q6-row (3)) of the survey questionnaire (appendix A.7). In panel b we pool respondents from the baseline group with those who received the *public-goods* letter to improve the statistical power in the test (N=137). The *public-goods* letter did not include any information regarding  $p$  and  $\theta$ .

Figure 1: Distribution of Statistics Shown in Audit-Statistics Letter Type

a. Audit Probability ( $p$ )

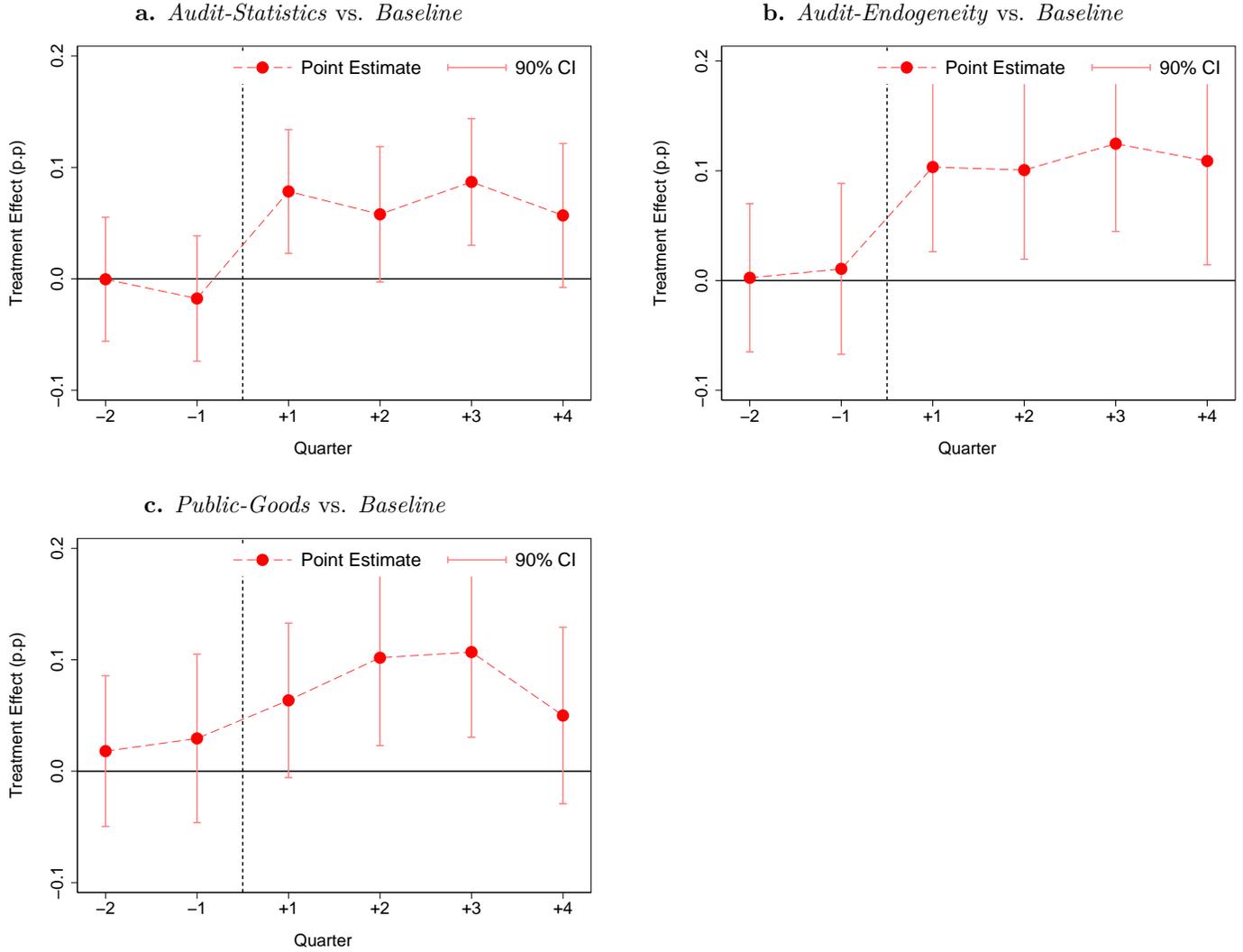


b. Penalty rate ( $\theta$ )



Notes: The data corresponds to the distribution of the information provided in the *audit-statistics* letter ( $N=10,272$ ). Panel a. presents the distribution of the probability of being audited ( $p$ ). Panel b represents the distribution of the average penalty rate ( $\theta$ ).  $p$  and  $\theta$  arise from the following procedure: 1) divide the firms in total sales revenues quintiles, 2) randomly draw a sample of 100 similar firms (i.e. from the same quintile) and 3) compute the average  $p$  and  $\theta$  from that sample. This algorithm lead to 950 different combinations of the two parameters.

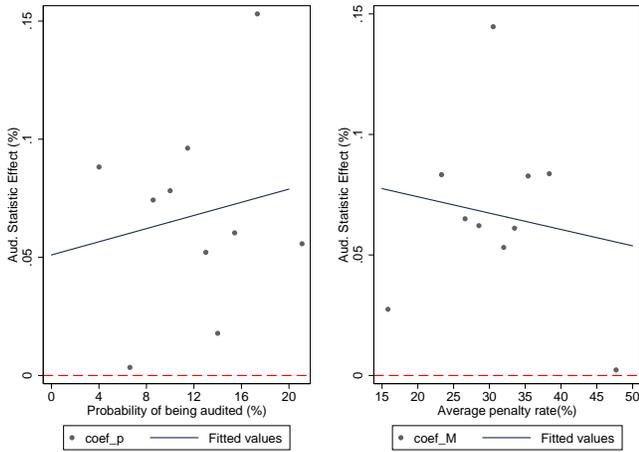
Figure 2: Average Effects of *Audit-Statistics*, *Audit-Endogeneity* and *Public-Goods* Messages: By Quarters



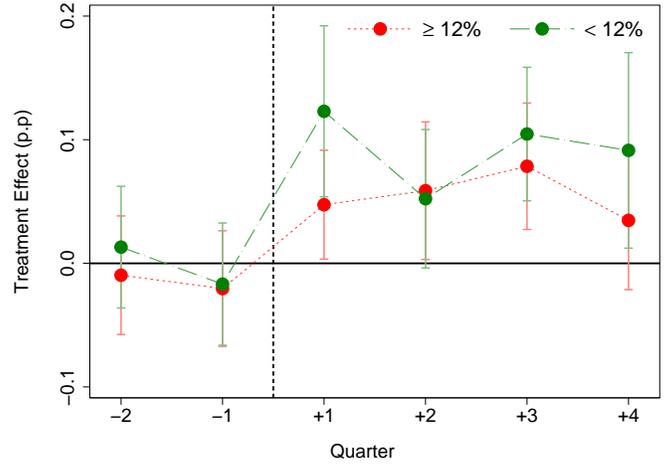
Notes: These figures plot the quarterly effect of each treatment arm when compared to the *baseline letter*. Panel a. ( $N=12,336$ ) presents the effect of the *audit-statistics* message on total quarterly VAT payments, while panel b. ( $N=4,103$ ) represents the effect of the *audit-endogeneity* message and panel c. ( $N=4,081$ ) depicts the effect of the *public-goods* message on the same outcome variable. Each point (red circle) in the plot represents the estimate of the effect of treatment on VAT payments for a specific quarter from two quarters before treatment up to four quarters after receiving the letter. Regressions do not include monthly pre-treatment controls. The estimates correspond to Poisson regressions. Confidence intervals, represented by red lines, are computed with heteroskedastic-robust standard errors.

Figure 3: Effects of *Audit-Statistics* and *Audit-Threat* Sub-Treatments: By Deciles and Quarters

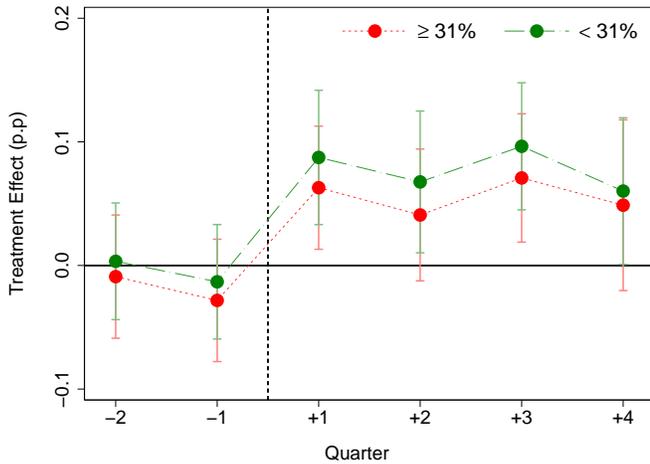
a. Effect of *audit-statistics* vs. *baseline*, by deciles of  $p$  and  $\theta$



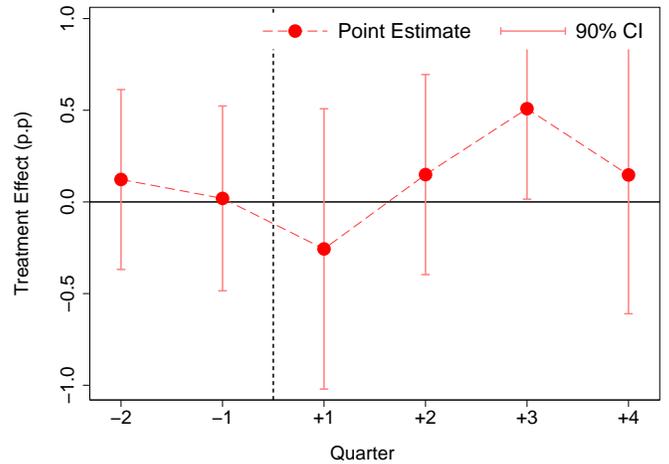
b. Effect of *audit-statistics* vs. *baseline*, by level of  $p$



c. Effect of *audit-statistics* vs. *baseline*, by level of  $\theta$



d. Effect of *audit-threat*,  $p = 0.50$  vs.  $p = 0.25$



Notes: Panel a. plots the effects of *audit-statistics* letter by decile of  $p$  and  $\theta$ . Panel b. (N=10,272) presents the effect of the  $p$  reported in the *audit-statistics* message on the total quarterly of VAT payments, while panel c. reports the same estimations for  $\theta$ . Panel d. (N=4,048) represents the effect of the *audit-threat* message (50% vs 25%). Each dot in panels b. c. and d. represents the estimate of the effect of treatment on VAT payments for a specific quarter from two quarters before treatment up to four quarters after receiving the letter. Red dots in panels b. and c. represent the effect for *audit-statistics* letter recipients with a reported  $por\theta$  above the median. Green dots represent the same effect but for those with reported  $p$  and  $\theta$  below the median. Regressions do not include monthly pre-treatment controls. The estimates correspond to Poisson regressions. Confidence intervals, represented by red and green lines, are computed with heteroskedastic-robust standard errors.

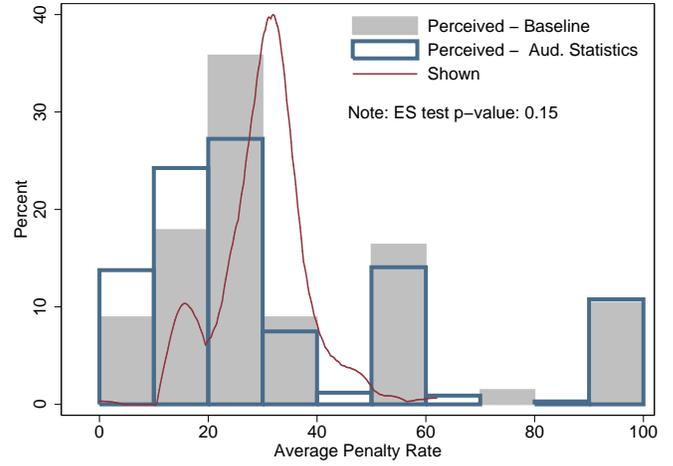
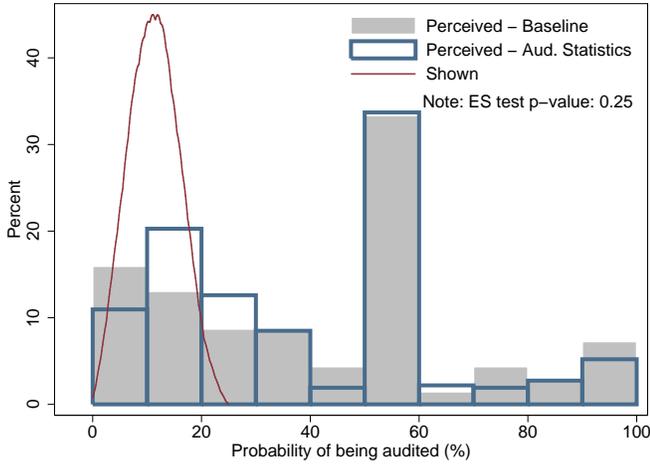
Figure 4: Survey Results: Perceived  $p$  and  $\theta$ , by Treatment Group

Audit Probability -  $p$

Penalty rate -  $\theta$

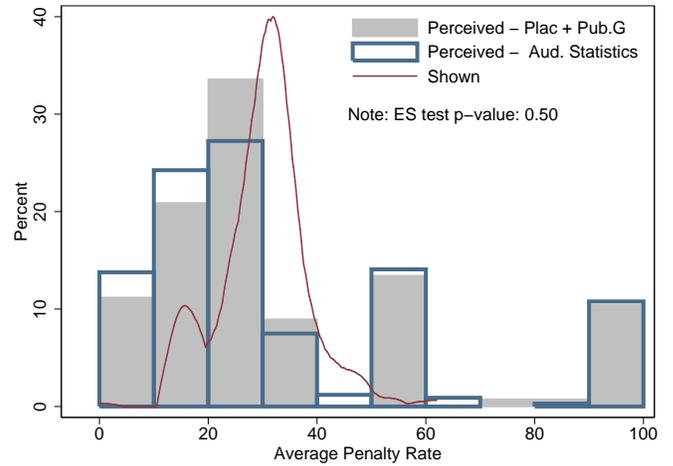
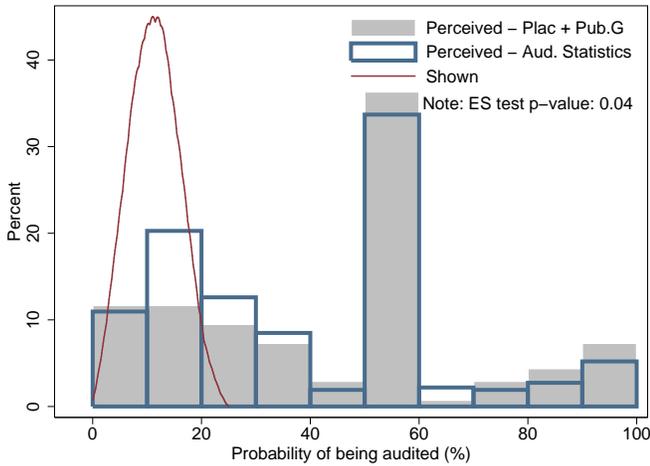
a. Audit-statistics vs. Baseline

b. Audit-statistics vs. Baseline



c. Audit-statistics vs. Baseline and Public-goods

d. Audit-statistics vs. Baseline and Public-goods



Notes: The histograms are based on survey responses from those self-reported as owners in the post-treatment survey. Perceived - Baseline (N=69) refers to survey respondents who received the *baseline* letter during the experimental stage, while Perceived - Aud. Statistics (N=365) refers to respondents who received *audit-statistics* letters and Public-goods (N=68) refers to recipients of the *public-goods* letters. The answers correspond to questions Q2 and Q4 (see full survey questionnaire in Appendix A.7). In panel a. the x-axis represents the probability of being audited; in panel b. it represents the average penalty rate. Perceived Baseline is the histogram for firm owners who received the *baseline* letter. Perceived Aud. Statistics refer to the histograms of firms that effectively received *audit-statistics* letters. “Shown” refers to the distribution of the information displayed in the *audit-statistics* letters.

## Online Appendix: For Online Publication Only

### A Replication Material: Letters and Survey

This appendix presents samples of the five letter types: *baseline* letter (A.1), *audit-statistics* letter (A.2), *audit-threat* letter (A.3), *audit-endogeneity* letter (A.4) and *public goods* letter (A.5). Additionally, Appendix A.6 presents a sample of the invitation email sent by the IRS to complete the online survey, and Appendix A.7 presents the module from that survey that we included with the questions that are most relevant for our experiment.

## A.1 Sample Letter: Baseline Letter



Montevideo, August 20<sup>th</sup> 2015

Mr./Ms. Taxpayer:

The DGI has the authority to perform inspections (see Art. 68 of the tax code) and routine audits of taxpayers on the basis of crosschecks and assessment of data compiled to detect oversights and inconsistency on tax returns as well as pending tax debts.

The aim of the DGI, and the primary challenge it faces, is to ensure the collection of revenue to sustain life in society. Additionally, its task is to generate a framework of fair and transparent competition where the failure of some to meet their obligations does not have an unfavorable impact on honest taxpayers. In order to meet these goals, inspections are performed in a routine fashion.

Your micro, small, or medium-sized business has been randomly selected to receive this information. *It is solely for your information and its receipt does not require you to present any documentation to the DGI offices.*

We ask you to comply with your tax obligations for the sake of the country we all want, a more and more developed Uruguay with greater and greater social cohesion.

Sincerely,

A handwritten signature in blue ink, appearing to be 'J. Serra', is written over a blue dotted grid. Below the signature, the text 'Lic. Joaquín Serra' is printed in blue.

El Director General de Rentas  
Lic. Joaquín Serra

Collection and Controls Division  
Internal Revenues Services

## A.2 Sample Letter: Audit-Statistics Letter



Montevideo, August 20<sup>th</sup> 2015

Mr./Ms. Taxpayer:

The DGI has the authority to perform inspections (see Art. 68 of the tax code) and routine audits of taxpayers on the basis of crosschecks and assessment of data compiled to detect oversights and inconsistency on tax returns as well as pending tax debts.

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

The aim of the DGI, and the primary challenge it faces, is to ensure the collection of revenue to sustain life in society. Additionally, its task is to generate a framework of fair and transparent competition where the failure of some to meet their obligations does not have an unfavorable impact on honest taxpayers. In order to meet these goals, inspections are performed in a routine fashion.

Your micro, small, or medium-sized business has been randomly selected to receive this information. *It is solely for your information and its receipt does not require you to present any documentation to the DGI offices.*

We ask you to comply with your tax obligations for the sake of the country we all want, a more and more developed Uruguay with greater and greater social cohesion.

Sincerely,

A blue ink signature of Lic. Joaquín Serra is written over a circular stamp. The stamp contains the text 'El Director General de Rentas' at the top and 'Lic. Joaquín Serra' at the bottom.

El Director General de Rentas  
Lic. Joaquín Serra

Collection and Controls Division  
Internal Revenues Services

### A.3 Sample Letter: Audit-Threat Letter



Montevideo, August 20<sup>th</sup> 2015

Mr./Ms. Taxpayer:

The DGI has the authority to perform inspections (see Art. 68 of the tax code) and routine audits of taxpayers on the basis of crosschecks and assessment of data compiled to detect oversights and inconsistency on tax returns as well as pending tax debts.

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

The aim of the DGI, and the primary challenge it faces, is to ensure the collection of revenue to sustain life in society. Additionally, its task is to generate a framework of fair and transparent competition where the failure of some to meet their obligations does not have an unfavorable impact on honest taxpayers. In order to meet these goals, inspections are performed in a routine fashion.

Your micro, small, or medium-sized business has been randomly selected to receive this information. *It is solely for your information and its receipt does not require you to present any documentation to the DGI offices.*

We ask you to comply with your tax obligations for the sake of the country we all want, a more and more developed Uruguay with greater and greater social cohesion.

Sincerely,

A handwritten signature in blue ink, appearing to be 'J. Serra', is written over a circular stamp. The stamp contains the text 'El Director General de Rentas' at the top and 'Lic. Joaquín Serra' at the bottom.

El Director General de Rentas  
Lic. Joaquín Serra

Collection and Controls Division  
Internal Revenues Services

## A.4 Sample Letter: Audit-Endogeneity Letter



Montevideo, August 20<sup>th</sup> 2015

Mr./Ms. Taxpayer:

The DGI has the authority to perform inspections (see Art. 68 of the tax code) and routine audits of taxpayers on the basis of crosschecks and assessment of data compiled to detect oversights and inconsistency on tax returns as well as pending tax debts.

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

The aim of the DGI, and the primary challenge it faces, is to ensure the collection of revenue to sustain life in society. Additionally, its task is to generate a framework of fair and transparent competition where the failure of some to meet their obligations does not have an unfavorable impact on honest taxpayers. In order to meet these goals, inspections are performed in a routine fashion.

Your micro, small, or medium-sized business has been randomly selected to receive this information. *It is solely for your information and its receipt does not require you to present any documentation to the DGI offices.*

We ask you to comply with your tax obligations for the sake of the country we all want, a more and more developed Uruguay with greater and greater social cohesion.

Sincerely,

A handwritten signature in blue ink, appearing to be 'J. Serra', is written over a circular blue stamp. The stamp contains the text 'El Director General de Rentas' at the top and 'Lic. Joaquín Serra' at the bottom.

El Director General de Rentas  
Lic. Joaquín Serra

Collection and Controls Division  
Internal Revenues Services

## A.5 Sample Letter: Public-Goods Letter



Montevideo, August 20<sup>th</sup> 2015

Mr./Ms. Taxpayer:

The DGI has the authority to perform inspections (see Art. 68 of the tax code) and routine audits of taxpayers on the basis of crosschecks and assessment of data compiled to detect oversights and inconsistency on tax returns as well as pending tax debts.

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

The aim of the DGI, and the primary challenge it faces, is to ensure the collection of revenue to sustain life in society. Additionally, its task is to generate a framework of fair and transparent competition where the failure of some to meet their obligations does not have an unfavorable impact on honest taxpayers. In order to meet these goals, inspections are performed in a routine fashion.

Your micro, small, or medium-sized business has been randomly selected to receive this information. *It is solely for your information and its receipt does not require you to present any documentation to the DGI offices.*

We ask you to comply with your tax obligations for the sake of the country we all want, a more and more developed Uruguay with greater and greater social cohesion.

Sincerely,

A blue ink signature of Lic. Joaquín Serra is written over a light blue dotted grid. The signature is a stylized, cursive 'J' followed by 'Serra'. Below the signature, the text 'Lic. Joaquín Serra' is printed in a small, blue, sans-serif font.

El Director General de Rentas  
Lic. Joaquín Serra

Collection and Controls Division  
Internal Revenues Services

## A.6 Sample Letter: Invitation to the Online Survey



Dear Taxpayer:

The DGI's strategic objectives for this period include improving taxpayer services. In 2013, the first Survey on the Costs of Tax Compliance for Small and Medium-Sized Businesses was administered with the support of the Inter-American Center of Tax Administrations (CIAT) and the United Nations (UN). The DGI, in conjunction with a group of academics, has designed a new version of the survey (for more information, visit [www.dgi.gub.uy](http://www.dgi.gub.uy)). You can give us your answers on the website where you will find instructions on how to fill out the simple questionnaire; the entire process should take no more than fifteen minutes.

### **Respond to survey**

To address these concerns, a random sample of taxpayers will receive a survey to be answered anonymously.

You are one of the randomly selected taxpayers, which is why you have received this communication. We are grateful for the time and effort you dedicate to assessing this questionnaire and to responding to it as precisely as possible.

Let me assure you that the survey is completely anonymous and the selection of recipients entirely random. The success of this project lies in the precision of your responses. It is on the basis of those responses and the real information they provide that the DGI will be able to hone the design, in the present and in the future, of its strategies to reduce the costs of compliance.

If you have any questions about this questionnaire, please send an e-mail to [encuestas@cedlas.org](mailto:encuestas@cedlas.org).

We would like to thank you once again for your contribution to this project, which we are sure will benefit all taxpayers.

Sincerely,

Joaquín Serra  
Director of the Income Tax Department

PS: If the "Respond to survey" link doesn't open, copy the following address in your browser:<https://URL>.

## A.7 Excerpt from the Online Survey Questionnaire

### Introductory Text:

We would like you to respond to a survey about the costs of paying taxes. We hope you have the ten minutes that responding to the questionnaire will require. We are interested in your opinion and hope you will be frank in your responses, which are anonymous and used only for statistical purposes. We would like to thank you for your participation.

### Questions Included in Main Module:

Q1) Have you been subject to a DGI audit (inspection or monitoring) at any point in the last three years?

- Yes.
- No.

Q2) In your opinion, what is the probability that the tax returns filed by a company like yours be audited at least once in the next three years (from 0% to 100%)?

%

Q3) How sure are you of your response?

- Not at all sure.
- A little sure.
- Somewhat sure.
- Very sure.

Q4) Let's imagine that a company like yours is audited and that tax evasion is detected. What, in your opinion, is the penalty (in %) as determined by law that the firm must pay in addition to the originally unpaid amount? For example, a fee of X% means that, for each \$100 not paid, the firm would have to pay those original \$100 plus \$X in fees.

%

Q5) How sure are you of your response?

- Not at all sure.
- A little sure.

## B A Calibration of Allingham and Sandmo (1972)

Let  $Y$  be the total value-added. Let  $\tau$  be the value added tax rate (in practice, it should include the VAT plus all the other taxes that the individual must pay as a consequence of declaring higher value-added, like for example income tax, benefits for formal employees, etc.). Let  $E$  be the amount to be under-declared (so  $\tau \cdot E$  is the amount evaded),  $p$  be the probability of audit and  $\theta$  be the penalty (as defined in audit-statistics). Finally  $\alpha$  is a social responsibility parameters, that in the Allingham and Sandmo (1972) model is fixed as 1 and decreases to 0 as social responsibility increases. The optimal evasion is given by maximizing the expected utility:

$$\max_E \frac{1-p}{1-\sigma} (Y - \alpha\tau(Y - E))^{1-\sigma} + \frac{p}{1-\sigma} (Y - \alpha\tau(Y - E) - (1 + \theta)\tau E)^{1-\sigma} \quad (\text{B.1})$$

In the traditional model ( $\alpha = 1$ ) the VAT remittances elasticities with respect to the audit parameters ( $p$  and  $\theta$ ) depend on the set of audit parameters, the tax level ( $\tau$ ), and the CRRA utility function parameters  $\sigma$

$$\frac{\partial\tau(Y - E)}{\partial p} \frac{p}{\tau(Y - E)} = -(1 - \tau) \frac{\frac{\partial x}{\partial p}(1 + \theta)}{(\theta x + 1)^2} \frac{p}{\left[\tau - (1 - \tau) \left(\frac{x-1}{1+\theta x}\right)\right]} \quad (\text{B.2})$$

$$\frac{\partial\tau(Y - E)}{\partial\theta} \frac{\theta}{\tau(Y - E)} = -(1 - \tau) \frac{(1 + \theta) \frac{\partial x}{\partial\theta} - x(x - 1)}{(\theta x + 1)^2} \frac{\theta}{\left[\tau - (1 - \tau) \left(\frac{x-1}{1+\theta x}\right)\right]} \quad (\text{B.3})$$

with

$$x = \left(\frac{p\theta}{1-p}\right)^{-\frac{1}{\sigma}}$$

$$\frac{\partial x}{\partial p} = -\frac{1}{\sigma} \left(\frac{p\theta}{1-p}\right)^{-\frac{\sigma+1}{\sigma}} \frac{\theta}{(1-p)^2}$$

$$\frac{\partial x}{\partial\theta} = -\frac{1}{\sigma} \left(\frac{p\theta}{1-p}\right)^{-\frac{\sigma+1}{\sigma}} \frac{p}{1-p}$$

In the model with social responsibility ( $\alpha < 1$ ), VAT remittances elasticities with respect to the audit parameters ( $p$  and  $\theta$ ) depend on the set of audit parameters, the tax level ( $\tau$ ), the CRRA utility function parameters  $\sigma$ , and the weight of the social responsibility *alpha*

$$\frac{\partial\tau(Y - E)}{\partial p} \frac{p}{\tau(Y - E)} = -(1 - \alpha\tau) \frac{\frac{\partial x_1}{\partial p}(1 + \theta)}{(\alpha + (1 + \theta - \alpha)p)^2} \frac{p}{\tau - (1 - \alpha\tau) \frac{x_1-1}{\alpha+x_1(1+\theta-\alpha)}} \quad (\text{B.4})$$

$$\frac{\partial \tau(Y - E)}{\partial \theta} \frac{\theta}{\tau(Y - E)} = -(1 - \alpha\tau) \frac{\frac{\partial x_1}{\partial \theta}(1 + \theta) - x_1(x_1 - 1)}{(\alpha + (1 + \theta - \alpha)p)^2} \frac{\theta}{\tau - (1 - \alpha\tau) \frac{x_1 - 1}{\alpha + x_1(1 + \theta - \alpha)}} \quad (\text{B.5})$$

We calibrate the model with two sets of parameters. In the first one, we use the actual parameters i.e. the level of audit probability ( $p$ ) is 0.113 and the amount of fines ( $\theta$ ) is 30.3% of the amount evaded. The second set of parameters are firm owner perceptions in the survey conducted after the experiment. This parameter in the case of audit probability is three times higher than the actual one at 0.376. In the case of  $\theta$ , the perceived penalty rate is about 31% which is similar to the actual penalty rate. For both parameter sets in the Allingham and Sandmo (1972) model, a rational individual would evade 100% of his tax duties for the range of risk aversion level used in the literature. Additionally, for perceived parameters we calibrate also with a social responsibility model

In Table B.1 we show the computed elasticities respect to  $p$  and  $\theta$  and the evasion rate assuming a CRRA utility function with a wide range of risk aversion parameters from 1 to 40. We calibrate the model with no social responsibility with the actual set of audit parameters in Panel A and the perceived audit parameters in Panel B. In Panel C, we calibrate the model with social responsibility and the perceived audit parameters.

Panel A of Table B.1 presents predicted elasticities with the mean value of actual audit characteristics. We find larger elasticities for those individuals with less risk aversion, but only for  $\sigma$  larger than 9.6 we find evasion rates lower than 1. Moreover, to find the evasion rate (26%) which is estimated for Latin America in Gómez-Sabaini and Jiménez (2012) we need the risk aversion coefficient at 35. This rate means, tax payers are indifferent between receiving USD 102.05 for sure than participating in a lottery with equal probabilities to receive USD 100 or USD 200.

Panel B of Table B.1 presents the predicted elasticities and aversion rate of the AS model calibrated with the perceived set of audit parameters. Here, the risk aversion required coefficient to find a 26% of evasion rate is also high (18.3). This risk aversion means that for the same lottery, taxpayers are indifferent between the lottery and a sure payment of USD 103.9.

The calibration in the model with social responsibility, we use  $\alpha = 0.59$  which is the parameter to obtain a evasion rate of 0.26 with CRRA parameter at 4. At this level of risk aversion, the model predicts a behavioral elasticity of tax payments with respect to the audit probability of 4.02, and a behavioral elasticity of tax payments with respect to the penalty rates of 1.64. This is our preferred calibration, because it does not rely on an extreme curvature of the utility function.

Table B.1: VAT Remittances Elasticities Respect to the Main Parameters. Calibrated in the Actual and Perceived Means

$\sigma$	A. Actual			B. Perceived			C. Perceived + Social Responsibility		
	$p = 0.113; \theta = 0.303; \alpha = 1$			$p = 0.367; \theta = 0.31; \alpha = 1$			$p = 0.367; \theta = 0.31; \alpha = 0.59$		
	$\frac{\partial \ln \tau(Y-E)}{\partial \ln p}$	$\frac{\partial \ln \tau(Y-E)}{\partial \ln \theta}$	$\frac{E}{Y}$	$\frac{\partial \ln \tau(Y-E)}{\partial \ln p}$	$\frac{\partial \ln \tau(Y-E)}{\partial \ln \theta}$	$\frac{E}{Y}$	$\frac{\partial \ln \tau(Y-E)}{\partial \ln p}$	$\frac{\partial \ln \tau(Y-E)}{\partial \ln \theta}$	$\frac{E}{Y}$
1			1			1			1
2			1			1	10.61	4.62	0.52
3			1			1	5.83	2.43	0.35
4			1			1	4.02	1.64	0.26
5			1			1	3.07	1.24	0.21
10	80.59	50.50	0.96	2.46	2.66	0.49	1.41	0.55	0.10
20	2.74	1.65	0.46	0.80	0.85	0.24	0.68	0.26	0.05
30	1.37	0.82	0.30	0.47	0.50	0.16	0.44	0.17	0.03
40	0.91	0.54	0.23	0.34	0.36	0.12	0.33	0.13	0.03

Notes: The predicted elasticities and evasion rates are obtained from three calibrations of the model from Appendix B. All specifications use the same tax rate  $\tau = 0.22$ .  $p$  denotes the probability that the tax report is eventually audited;  $\theta$  denotes the penalty rate for evasion;  $\sigma$  denotes the Coefficient of Relative Risk Aversion;  $\alpha$  denotes the social responsibility parameter;  $Y$  and  $E$  denote the tax base amount and the evaded amount, respectively. In Panel A,  $\alpha = 0$  and the audit parameters are calibrated with the average probabilities and evasion rates from the experimental sample. Panel B is similar to Panel A, but the results in B use the perceived audit parameters from the post-treatment survey data. Panel C is similar to Panel A, but the results are derived with  $\alpha = 0.59$  instead of  $\alpha = 0$  (this parameter was calibrated so that the model fits an estimated evasion rate of 26% when  $\sigma = 4$ ).

# C Additional Results, Specification and Robustness Checks

## C.1 Robustness Checks of Baseline Specification

To assess the robustness of the baseline results in Section 4.1, Table C.1 presents alternative estimates based on different specifications. The first two columns present estimates of the treatment effects based only on the extensive margin of VAT payments: i.e. the outcome is 1 if the firm made at least one payment in the post-treatment period, and 0 otherwise. Column (1) presents results from a linear probability model, while column (2) presents Probit estimates. There is not much variation in the extensive margin: 96% of firms in the sample made positive payments in the post-treatment period. This is a direct byproduct of the selection of the subject pool: we excluded all firms who did not make at least three payments in the 12 months before the treatment assignment. The effects of the three different messages on the extensive margin are close to zero and not statistically significant.

The specifications in columns (3), (4) and (5) of Table C.1 use the amount of VAT payments as the dependent variable. Column (3) corresponds to our baseline Poisson specification. In turn, column (4) presents estimates based on Tobit regressions and (5) presents OLS estimates. The Poisson model has a main advantage in this context: it deals naturally with bunching of payments at exactly zero, while still allowing for the effects to be proportional. The OLS specification, instead, does not deal with the bunching at zero and does not allow for the effects on amounts to be proportional. The Tobit specification is more appropriate than OLS since it takes into account the censored nature of the data at zero, but it does not allow for the effects to be proportional.

The results from columns (3), (4) and (5) of Table C.1 are identical in terms of the signs and statistical significance of the coefficients, indicating that the results are robust to the three alternative specifications. If anything, the effects are statistically more significant when using the OLS and Tobit models. Even though the results from the Poisson, OLS and Tobit models are not directly comparable in terms of magnitudes, they are roughly consistent. For example, the Tobit model suggests an effect of audit statistics of USD 480 (p-value=0.001). Since the average outcome is USD 6,465, this Tobit coefficient amounts to an effect of about 7.4%, which is in the same order of magnitude than the Poisson model, which indicates an effect of *audit-statistics* of 6.3% (p-value=0.013). .

Table C.1: Average Effects of *Audit-Statistics*, *Audit-Endogeneity* and *Public-Goods* Messages: Alternative Specifications

	Prob. Making Positive VAT Payments		VAT Payments		
	OLS (1)	Probit (2)	Poisson (3)	OLS (4)	Tobit (5)
<b>a. Audit - Statistics (N= 10,272) vs Baseline (N= 2,064)</b>					
Post-Treatment	-0.001 (0.004)	-0.019 (0.066)	0.063** (0.025)	0.493*** (0.140)	0.480*** (0.147)
Pre-Treatment			-0.008 (0.021)	0.047 (0.128)	0.049 (0.128)
<b>b. Audit - Endogeneity (N= 2,039) vs Baseline (N= 2,064)</b>					
Post-Treatment	0.001 (0.006)	-0.006 (0.085)	0.074** (0.032)	0.591*** (0.189)	0.592*** (0.195)
Pre-Treatment			-0.006 (0.027)	0.057 (0.169)	0.060 (0.169)
<b>c. Public - Goods (N= 2,017) vs. Baseline (N= 2,064)</b>					
Post-Treatment	0.006 (0.006)	0.045 (0.087)	0.043 (0.030)	0.333* (0.171)	0.357** (0.177)
Pre-Treatment			-0.004 (0.026)	0.059 (0.162)	0.065 (0.162)
Baseline Mean	0.943		6.465		

Notes: \* significant at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. Robust standard errors. Panel a. compares the *audit-statistics* message with the *baseline* letter while panels b. and c. replicate the analysis for the *audit-endogeneity* and *public goods* messages respectively. In the first row of each panel we use post-treatment information about the corresponding outcome, while the second row presents a falsification test in which we estimate the same regression with pre-treatment values of the outcomes of interest. All regressions are estimated with a set of monthly controls that correspond to the year before the outcome, i.e. in the post treatment outcome we include monthly VAT payment controls from September, 2014 to August, 2015 and in pre-treatment outcome we include the same variables for the September, 2013 - August 2014 period. We also restrict the analysis to those firms that effectively received the letter. Columns (1), (2) and (3) present the effect of treatment by type of payment. Columns (1) and (2) show the treatment effect on the extensive margin using two alternative strategies. Column (1) presents the treatment effect on the probability of making at least one VAT payment in the post treatment period using a OLS model. Column (2) replicates the same analysis using a probit model. Columns (3), (4) and (5) present different estimation strategies for the intensive margin, i.e. the total amount of VAT paid. In column (4) we present the results of a Poisson estimation, while column (5) uses an OLS regression and column (6) depicts the Tobit estimation results. The last row of the table presents the baseline mean for each group of outcomes.

Table C.2: Effects of *Audit-Statistics* and *Audit-Threat* Sub-Treatments: Alternative Specifications

	Prob. Making Positive VAT Payments		VAT Payments		
	OLS (1)	Probit (2)	Poisson (3)	OLS (4)	Tobit (5)
<b>a. Audit - Statistics (N= 10,272)</b>					
Audit Probability (%)					
Post-Treatment	0.007 (0.040)	0.376 (0.619)	0.030 (0.236)	-0.441 (1.617)	0.141 (1.728)
Pre-Treatment			0.025 (0.115)	0.183 (0.943)	0.212 (0.945)
Penalty Size (%)					
Post-Treatment	0.002 (0.021)	0.079 (0.316)	-0.118 (0.115)	-0.362 (0.856)	-0.319 (0.896)
Pre-Treatment			-0.001 (0.088)	-0.123 (0.785)	-0.133 (0.785)
<b>b. Audit - Threat Letters (N= 4,048)</b>					
Post-Treatment	0.009 (0.026)	0.160 (0.320)	0.376* (0.210)	1.325 (0.900)	1.253 (0.940)
Pre-Treatment			-0.342* (0.178)	-0.958 (0.695)	-0.954 (0.699)
Baseline Mean	0.943		6.465		

Notes: \* significant at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. Robust standard error. Panel a. presents the effect of providing different information regarding  $p$  and  $\theta$  in the *audit-statistics* message. Panel b. compares the two *audit-threat* messages, i.e. the 50% threat of audit vs. the 25% threat of audit. Rows (1) and (3) of panel a. present the effect of informing an additional percentage point of  $p$  and  $\theta$  respectively on post treatment VAT payments. Rows (2) and (4) present a falsification test in which we estimate the same regression but using pre-treatment information. All regressions are estimated with a set of monthly controls that correspond to the year before the outcome, i.e. in the post treatment outcome we include monthly VAT payment controls from September, 2014 to August, 2015 and in the pre-treatment outcome we include the same variables for the September, 2013 - August 2014 period. We also restrict the analysis to firms that received the letter according to the postal service. Row (1) in panel b. presents the post treatment effect of receiving the letter of 50% threat relative to receive the 25% letter. These coefficients can be interpreted as elasticities. Row (2) of panel b. replicates the estimates for the pre-treatment outcomes. Column (1) presents the treatment effect on the probability of making at least one VAT payment in the post treatment period using a OLS model. Column (2) replicates the same analysis using a probit model. Columns (3), (4) and (5) present different estimation strategies for the intensive margin, i.e. the total amount of VAT paid. In column (4) we present the results of a Poisson estimation, while column (5) uses an OLS regression and column (6) depicts the Tobit estimation results. The last row of the table presents the baseline mean for each group of outcome.

Table C.3: Effects of *Audit-Statistics* and *Audit-Threat* Sub-Treatments: VAT Payment Timing and Other Taxes

	VAT, By Payment Timing			VAT vs. Other Taxes		
	Retroactive (1)	Concurrent (2)	Retroactive + Concurrent (3)	VAT (4)	Other (5)	VAT + Other (6)
<b>a. Audit - Statistics (N= 10,272)</b>						
Audit Probability(%)						
Post-Treatment	-1.484 (1.034)	0.123 (0.241)	0.030 (0.236)	0.030 (0.236)	0.465 (0.343)	0.264 (0.229)
Pre-Treatment	-1.138 (0.766)	0.144 (0.120)	0.025 (0.115)	0.025 (0.115)	0.214 (0.304)	0.081 (0.142)
Penalty Size (%)						
Post-Treatment	0.997 (0.725)	-0.220** (0.106)	-0.118 (0.115)	-0.118 (0.115)	-0.018 (0.166)	-0.086 (0.121)
Pre-Treatment	-0.087 (0.437)	-0.004 (0.092)	-0.001 (0.088)	-0.001 (0.088)	-0.283** (0.143)	-0.152* (0.081)
<b>b. Audit - Threat Letters (N= 4,048)</b>						
Post-Treatment	0.864 (0.871)	-0.011 (0.205)	0.376* (0.210)	0.376* (0.210)	0.045 (0.164)	0.419*** (0.162)
Pre-Treatment	0.521 (0.698)	-0.215 (0.176)	-0.342* (0.178)	-0.342* (0.178)	-0.201 (0.170)	-0.195 (0.141)

Notes: significant at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. Robust standard errors. Panel a. presents the effect of providing different information regarding  $p$  and  $\theta$  in the audit-statistics message. Panel b. compares the two audit-threat messages, i.e. the 50% threat of audit vs. the 25% threat of audit. Rows (1) and (3) of panel a. present the effect of informing an additional percentage point of  $p$  and  $\theta$  respectively on post treatment VAT payments. Rows (2) and (4) show a falsification test in which we estimate the same regression but using pre-treatment information. All regressions are estimated with a set of monthly controls that correspond to the year before the outcome, i.e. in the post-treatment outcome we include monthly VAT payments controls from September, 2014 to August, 2015 and in pre-treatment outcome we include the same variables for the September, 2013 - August 2014 period. We also restrict the analysis to firms that received the letter according to the postal service. Row (1) in panel b. represents the post treatment effect of receiving the letter of 50% threat relative to receive the 25% letter. These coefficients can be interpreted directly as elasticities. Row (2) of panel b. replicates the estimates for the pre-treatment outcomes. Columns (1), (2) and (3) show the effect of treatment by type of payments. Columns (1) and (2) present separately the effect of treatment on current and retroactive VAT payments, while column (3) presents the overall effect. Columns (4), (5) and (6) present the results by type of tax. While column (4) depicts the effect of the treatment in post experiment VAT payments, column (5) presents the effect on the rest of taxes considered and column (6) presents the effect on the total amount of taxes paid by the firms.

## C.2 Alternative Specifications for Audit Probabilities and Fines

Table C.4 presents the results for an alternative specification of the elasticity estimation. Instead of estimating the elasticities w.r.t.  $p$  and  $\theta$  separately, we estimate the elasticity w.r.t.  $p * \theta$ .

$$Y_i = \alpha + \gamma_{p*\theta} \cdot p_i * \theta_i + X_i\delta + \epsilon_i \quad (\text{C.1})$$

As in the model where  $p$  and  $\theta$  were included separately, the elasticity with these alternative specification is statistically and economically insignificant too

Table C.4: Effects of Audit-Statistics Sub-Treatments: Alternative Specification of  $p \cdot \theta$

	All (1)	Above Median Size		Recently Audited	
		Yes (2)	No (3)	Yes (2)	No (3)
<b>a.</b> Audit - Statistics Letters (N= 10,272)					
p* $\theta$ (%)					
Post-Treatment	-0.373 (0.530)	-0.133 (0.672)	-0.216 (0.708)	1.523 (0.969)	-0.537 (0.605)
Pre-Treatment	0.049 (0.316)	0.218 (0.347)	-0.361 (0.647)	-0.040 (0.764)	0.030 (0.346)
Observations	10,272	5,147	5,125	1,139	9,133

Notes: \* significant at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. Robust standard error. Panel a. presents the effect of providing different information regarding  $p$  and  $\theta$  in the *audit-statistics* message. Row (1) of panel a. present the effect of informing an additional percentage point of  $p$  times  $\theta$  respectively on the post treatment VAT payments. Row (2) presents a falsification test in which we estimate the same regression but using pre-treatment information. All regressions are estimated with a set of monthly controls that correspond to the year before the outcome, i.e. in the post treatment outcome we include monthly VAT payment controls from September, 2014 to August, 2015, and in pre-treatment outcome we include the same variables for the September, 2013 - August 2014 period. We also restrict the analysis to firms that effectively received the letter according to the postal service. The first column presents the results for the total number of firms that received each letter. Columns (2) and (3) present the effects for firms that sell goods and firms that sell services.

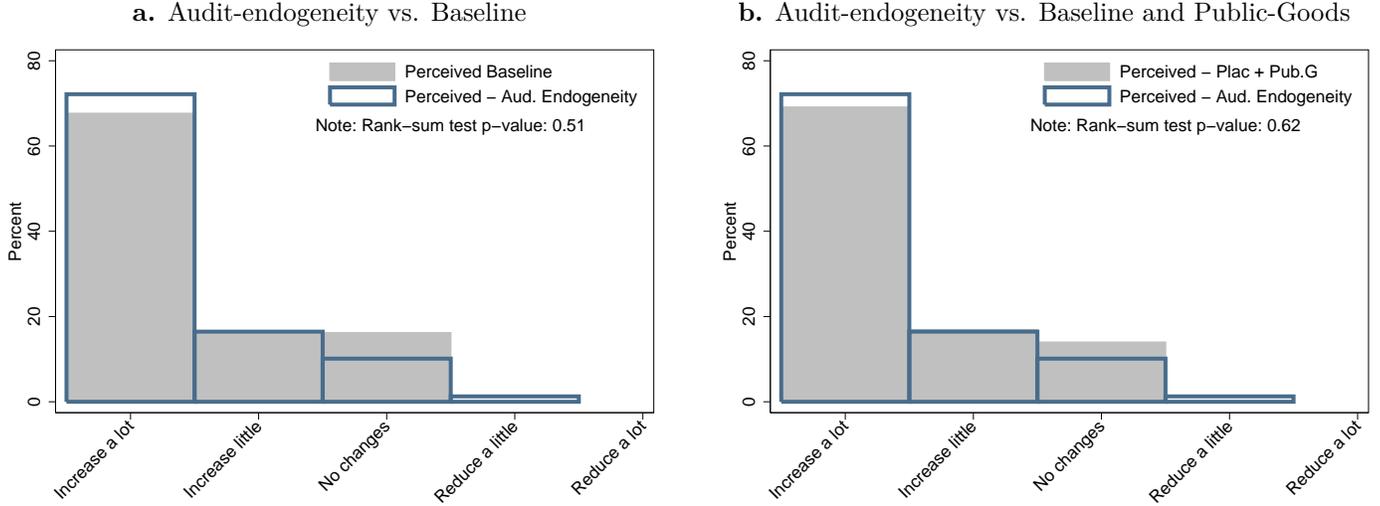
### C.3 Additional Results: Beliefs About Audit Endogeneity

As in the case of the *audit-statistics* treatment arm, we conducted a survey of letter recipients in which we included a specific question to assess whether the information provided in the letter had an impact on beliefs about the endogeneity of audits:

Perceived Audit Endogeneity: “In your opinion, if a firm that evades taxes doubles the amount it is evading, what is the effect on its probability of being audited?” The possible answers were: It would increase significantly; It would increase slightly; It would not change; It would diminish slightly; It would diminish significantly.

The distribution of responses to this question about the perceived endogeneity of audits is depicted in Figure C.1. The distribution of perceptions in the *baseline* letter suggests that firms were already aware of this endogeneity. In line with the previous results in Section 5.2, relative to the *baseline* group, there is no statistically significant differences in the distribution of perceptions for the *audit-endogeneity* group (p-value of 0.61). In a scale from 1 to 5, where 1 is “more evasion significantly increases the probability of being audited”, and 5 means “more evasion significantly diminish the probability of being audited”, the average belief was 1.49 the *baseline group* and 1.14 for the *audit-endogeneity* group (Table C.5).

Figure C.1: Perception of Endogeneity of Audits

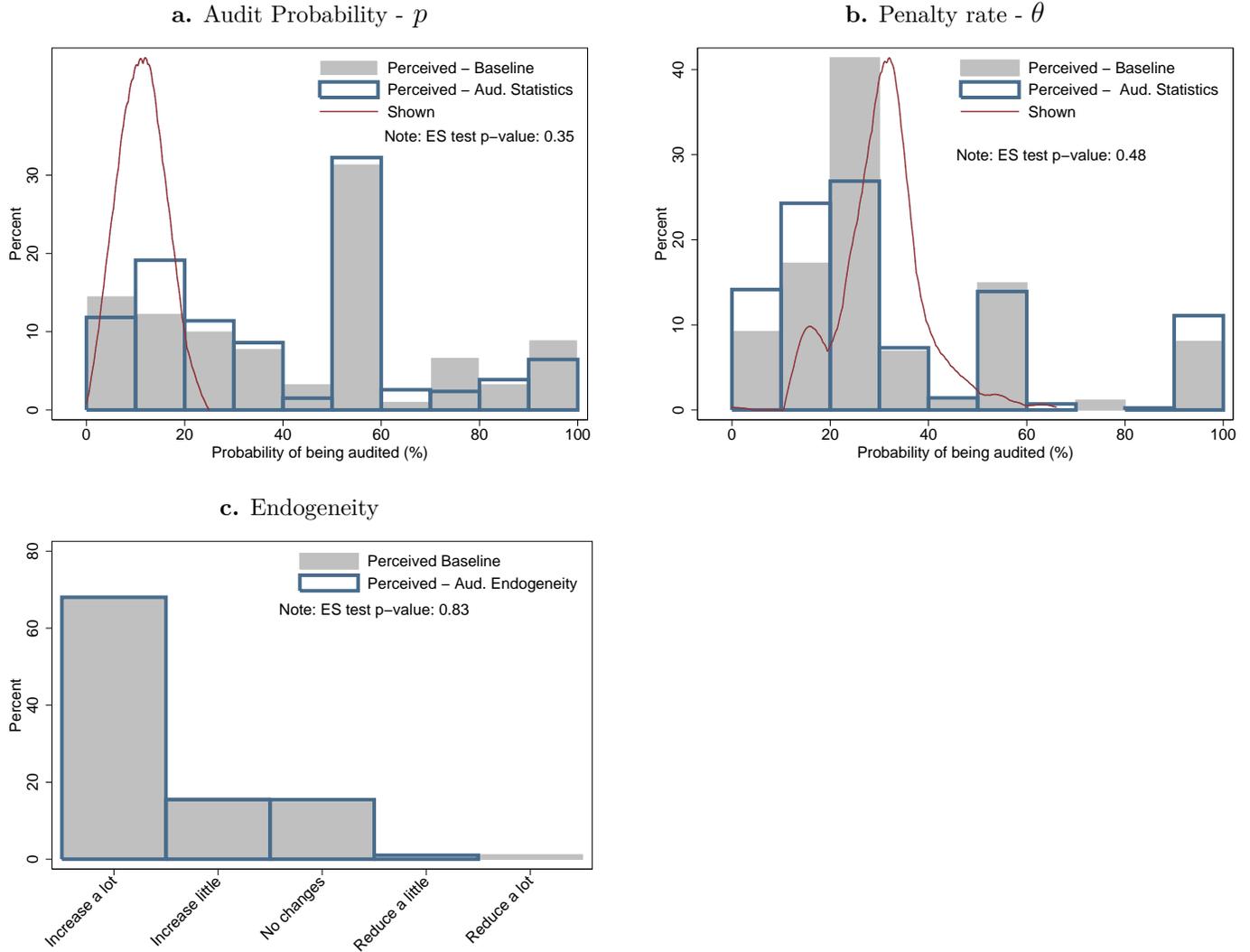


Notes: Histograms are based on responses to the post treatment survey by respondents self-identified as owners. Perceived - Baseline (N=69) refers to respondents who received the *baseline letter* during the experimental stage, while Perceived Endogeneity (N=79) refers to respondents who received *audit-endogeneity* letters and Public-goods (N=68) refers to recipients of the *public-goods* letters. These answers correspond to the question Q6 of the survey questionnaire (see the full questionnaire in Appendix A.7). The x axis represents the different categories allowed in the relationship between evasion and probability of being audited question. Perceived Baseline refers to the histogram of the owners of firms that received the *baseline letter*. Perceived Endogeneity refers to the histograms of firms that effectively received *audit-endogeneity* letters.

## C.4 Additional Results: Robustness to the inclusion of Non-Owners

In section 5.2 and Appendix C.3 we presented the results for survey respondents that self-declared as owners. In this appendix we present estimations for all respondents. The results are robust to the ones found for the sub-sample of owners.

Figure C.2: Distribution of Beliefs, by Treatment Group: Robustness to the Inclusion of Non-Owners



Notes: The histograms are based on responses to the post-treatment survey for all respondents. Perceived - Baseline (N=89) refers to respondents who received the *baseline letter* during the experimental stage, while Perceived - Aud. Statistics (N=465) and Perceived Endogeneity (N=97) refers to respondents who received *audit-statistics* and *audit-endogeneity* letters respectively. These answer correspond to the questions Q2, Q4 and Q6 of the survey questionnaire (see the full questionnaire in Appendix A.7). In panel a. the x-axis represents the probability of being audited; in panel b. it represents the average penalty rate while in panel c. it represents the different categories allowed in the relationship between evasion and probability of being audited question. Perceived Baseline refers to the histogram for responses of firm owners who received the *baseline letter*. Perceived Aud. Statistics and Perceived Endogeneity refers to the histograms for firms that received *audit-statistics* and *audit-endogeneity* letters. “Shown” represents the distribution of the information contained in the *audit-statistics* letter.

Table C.5: Effects of *Audit-Statistics* on Survey Beliefs

	Baseline (1)	Audit Endogeneity (2)	p-value (3)
<b>Panel a.</b>			
Perceived End.	1.49 (0.09)	1.41 (0.08)	0.515
 <b>Panel b.</b>			
	Baseline + Public Goods	Audit Endogeneity	p-value
Perceived End.	1.45 (0.06)	1.41 (0.08)	0.673

Notes: The table is based on responses from firm owners or those with missing values in the question regarding who answer the survey . In panel a. Column (1) (N=69), refers to respondents who received the *baseline letter* during the experimental stage. Column (2): “Endogeneity” (N=79 for Endogeneity) refers f to respondents who received the *audit-statistics* letter (rows 1 and 2) while in row (3) it refers to the group of taxpayers that received the *audit-endogeneity* letter. Column (3) presents the p-value of a test comparing the mean endogeneity perception between firms in the *baseline* and in the *audit-statistics* groups (Q6-row (3)) (see the survey questionnaire in Appendix A.7). The results in panel b are obtained by pooling the *baseline* group and respondents who received the *public-goods* letter to improve the statistical power of the test (N=137). The *public-goods* letter did not include any information regarding audit probabilities or their endogeneity.