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Fairly Random: On Compensating Audited Taxpayers

SARAH B. LAWSKY

Some academics and politicians have proposed that taxpayers should be reimbursed for costs of randomly imposed tax audits, because, they argue, randomly imposing audit costs is unfair. But none of those proposing audit compensation have explained why randomly imposed audit costs are unfair, or why, if these randomly imposed costs are unfair, this unfairness necessarily means that taxpayers should be compensated. These are important questions because explicit randomness is an essential tool for tax enforcement, and for other areas of law, but its use may be limited if randomness is equated with unfairness.

The Article argues that it is fair not to compensate randomly audited taxpayers for their audit costs, because the availability of insurance against random audit costs cures fairness concerns under luck egalitarianism. Fairness may nonetheless matter for a less obvious reason: notwithstanding philosophical arguments to the contrary, individuals may perceive random audits as unfair. Empirical work has shown that individuals have a taste for fairness in tax law, and that the perception that tax law is unfair may reduce tax compliance. Therefore, perceived unfairness should be of concern to welfarists, among others.

Based on a comparison of random audits with other burdens randomly imposed by the government, the Article concludes that perceived unfairness may warrant nominal compensation for random audit costs. The costs of the perceived unfairness of random audits, as opposed to other types of randomly imposed burdens, may be particularly high because of general ignorance about, and negative perceptions of, our tax system. Compensation for random audit costs is therefore warranted not because it is actually unfair to impose audit costs randomly, but rather because such compensation may help to overcome perceptions of unfairness and thus to increase overall tax compliance.

ARTICLE CONTENTS

I. INTRODUCTION	163
II. RANDOM AUDITS.....	164
A. THE VALUE OF RANDOM AUDITS.....	164
B. THE COMPENSATION PROPOSAL: BEGGING THE UNFAIRNESS QUESTION	168
III. ARE UNCOMPENSATED RANDOM AUDIT COSTS UNFAIR?	170
A. WHAT IS FAIR?.....	171
B. AUDIT INSURANCE.....	174
IV. WELFARISM AND PERCEIVED FAIRNESS	180
A. WELFARISM.....	181
B. A TASTE FOR FAIRNESS IN THE TAX LAW.....	182
C. WELFARISM AND OPTIMAL TAXATION.....	186
D. THE COST OF PERCEIVED UNFAIRNESS	191
V. WHEN DOES COMPENSATION MAKE SENSE IN THE REAL WORLD?	194
A. CHECKPOINT SEARCHES.....	195
B. JURY SERVICE	197
C. MILITARY SERVICE.....	200
D. RANDOM AUDITS: A COMPARISON	204
VI. CONCLUSION	207



Fairly Random: On Compensating Audited Taxpayers

SARAH B. LAWSKY*

I. INTRODUCTION

Randomness is underrated. Explicit randomness is an essential tool in tax enforcement, as it is in other areas of law, but its usefulness may be limited if this randomness is, or is perceived as, unfair. This Article therefore focuses on one way that the tax system currently employs explicit randomness and evaluates the claim that this explicit randomness unfairly allocates costs among taxpayers.

Some academics and politicians have proposed that taxpayers should be reimbursed for the costs of purely random audits.¹ As part of this argument for compensation, the claim is often made that randomly imposed audit costs are unfair, and that this unfairness is relevant to whether taxpayers should be compensated for audit costs.² However, none of those proposing audit compensation have explained why randomly imposed audit costs are unfair, or why, if these randomly imposed costs are unfair, this unfairness necessarily means that taxpayers should be compensated. In contrast, this Article directly addresses the questions of fairness that underlie proposals to compensate taxpayers who are randomly selected for audit, and concludes that it is generally fair to impose audit

* Associate Professor of Law, George Washington University Law School. Thanks to Lily Batchelder, Joshua Blank, Noel Cunningham, Elizabeth Emens, Brian Galle, Ellen Lawsky, Jeffrey Lax, Karen Olsson, Deborah Schenk, Daniel Shaviro, Geoffrey Stone, Cass Sunstein, Joshua Tate, David Weisbach, and Ethan Yale for helpful discussions and for comments on earlier drafts.

¹ See, e.g., Joseph Bankman, *Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs*, 31 OHIO N.U. L. REV. 1, 9 (2005) (proposing compensating taxpayers for random audit costs); Joseph Bankman, *Who Should Bear Tax Compliance Costs?* (Stanford Law Sch., John M. Olin Program in Law & Econ., Working Paper No. 279, 2004), available at <http://ssrn.com/abstract=519783> [hereinafter Bankman, *Who Should Bear Tax Compliance Costs?*] (proposing compensating taxpayers for random audit costs); Ryan J. Donmoyer, *Citing Budget Uncertainties, IRS Delays TCMP Start Until December*, 95 TAX NOTES TODAY 178-1, Sept. 12, 1995, available at LEXIS, News Library, TNT File (quoting Representative Nancy Johnson as proposing compensation for audit costs); George Guttman, *The Taxpayer Compliance Measurement Program: Is It Necessary?*, 95 TAX NOTES TODAY 109-11, June 6, 1995, available at LEXIS, News Library, TNT File (“Some have proposed reimbursing taxpayers for the added burdens brought by a TCMP audit”); David L. Keating, *National Taxpayers Union Foundation’s Testimony at W&M Oversight Hearing on TCMP*, 95 TAX NOTES TODAY 140-46, July 19, 1995, available at LEXIS, News Library, TNT File (proposing compensating taxpayers for random audit costs); Warren Rojas, *Information Gap Bars Compliance Compensation, Treasury Officials Say*, 2004 TAX NOTES TODAY 24-4, Feb. 5, 2004, available at LEXIS, News Library, TNT File (discussing Professor Bankman’s proposal); see also discussion *infra* notes 36–39 and accompanying text.

² Compare *infra* Part II.B, with *infra* note 179.

costs randomly without compensation.

Notwithstanding this fairness, however, people may still perceive random, uncompensated audits as unfair. Because people have a taste for fairness in tax law, and because compliance may be reduced if people perceive tax law as unfair, this perceived unfairness should be of concern to welfarists and others who seek to increase overall social welfare.

Part II first explains why random audits are crucial to effective enforcement and then describes the claim that random audits are unfair and that to mitigate this unfairness, taxpayers should be compensated for the costs imposed by random audits.³ Part III argues that randomly imposing audit costs, and not compensating taxpayers for these costs, is in fact fair in general, though there may be some exceptions to this general rule, particularly as it applies to low-income taxpayers.⁴ Part IV describes welfarism and explains why perceived unfairness of random audits should matter to welfarists.⁵ Part V compares random audits with other burdens the government randomly imposes on individuals to get a sense of whether random audit costs involve the type of unfairness that should be remedied by compensation.⁶ Based on this comparison, the Article tentatively resolves that perceived unfairness may warrant some compensation for random audit costs.⁷ This compensation is desirable not because randomness itself is unfair, but rather because people do not understand how audit selection works and have generally negative perceptions of our tax system. Part VI concludes.⁸

II. RANDOM AUDITS

A. *The Value of Random Audits*

The Internal Revenue Service (IRS) selects very few returns for audit randomly, but random audits are crucial to effective enforcement of tax laws. This Part explains the three ways the IRS selects individuals' tax returns for audit,⁹ and the role that randomness plays in that selection and in other areas of tax enforcement and compliance.

1. *IRS Projects and Automatic Audits*

The IRS examines returns with "certain features" individually to

³ See *infra* Parts II.A.3, II.B.

⁴ See *infra* Part III.

⁵ See *infra* Part IV.

⁶ See *infra* Part V.

⁷ See *infra* Part V.

⁸ See *infra* Part VI.

⁹ Methods for selecting individuals' returns for audit differ from methods used to select other types of returns for audit.

determine whether they should be audited.¹⁰ For example, the IRS may audit individuals whose returns were prepared by someone whom the IRS has identified as “questionable”; individuals whose returns involve illegal income; returns that are referred to the IRS by, for example, state tax agencies; or returns that are picked out because of particular “IRS projects.”¹¹ Previous IRS projects have studied, among other groups, taxpayers who claimed the earned income tax credit; taxpayers who claimed exemptions for dependents who also appeared on other returns; individuals who operated certain types of bars and restaurants in Ohio; individuals in Illinois who filed dubious information regarding profits and losses from their sole proprietorships; individuals who claimed business losses that they did not actually incur so that they would qualify for the earned income tax credit; and certain individuals in Missouri who had failed to pay self-employment tax.¹² Other “automatic audits” include audits of returns involving narcotics money or known tax shelters.¹³ The IRS selects these special projects or automatic audits because it already has reason to believe that these groups tend to underpay taxes, and therefore a high percentage of these audits result in additional tax revenue.¹⁴

2. Statistical Selection

The IRS selects some returns for audit based on statistical profiling. The IRS screens all individual returns with a computer program that analyzes a return’s basic characteristics to determine the probability that auditing the return will result in an upward adjustment.¹⁵ Different return characteristics are weighted, and then the weights are added together to arrive at a numerical score.¹⁶ The computer program that performs this screening applies what is known as the “Discriminant Index Function,” or “DIF,” and thus a return’s score is its “DIF score.” The DIF appears to be an effective method for selecting returns to audit because it permits the IRS to focus its audits on returns that are more likely to yield additional tax revenue. In 1968, the DIF did not yet exist, and forty-three percent of audited returns resulted in no change.¹⁷ That is, forty-three percent of audited returns provided no additional tax revenue.¹⁸ In 1994, returns

¹⁰ INTERNAL REVENUE MANUAL § 4.19.11.1.5 (2007).

¹¹ U.S. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS’ RETURN SELECTION PROCESS 4–5 (1999) [hereinafter IRS’ RETURN SELECTION PROCESS].

¹² U.S. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS’ USE OF RANDOM SELECTION IN CHOOSING TAX RETURNS FOR AUDIT 24 (1998) [hereinafter IRS’ USE OF RANDOM SELECTION].

¹³ IRS’ RETURN SELECTION PROCESS, *supra* note 11, at 5.

¹⁴ For example, from 1992 to 1994, only nineteen percent of books and records returns selected due to IRS projects were closed with no change to the amount of tax due. *Id.*

¹⁵ INTERNAL REVENUE MANUAL § 4.19.11.1.4 (2007).

¹⁶ INTERNAL REVENUE MANUAL § 4.19.11.1.5.1 (2007).

¹⁷ George Guttman, *News Analysis—Who Should the IRS Be Auditing?*, 2000 TAX NOTES TODAY 49–4, Mar. 13, 2000, available at LEXIS, News Library, TNT File.

¹⁸ *Id.*

selected for audit based on DIF scores had only a nineteen percent no-change rate—that is, only nineteen percent of returns selected for audit using the DIF provided no additional tax revenue.¹⁹

The portion of audited returns selected for audit using the DIF varies widely from year to year, depending on the IRS's priorities in a given year,²⁰ but the DIF remains crucial to the IRS's enforcement efforts. Overall, between 1992 and 1994, inclusive, DIF scores were used to select fifty-nine percent of the returns subject to "books and records" audits, that is, audits that could not be resolved simply by correspondence,²¹ but rather involved the government's having to meet the taxpayer face-to-face and review his books and records.²²

3. Random Selection

Finally, a tiny fraction of returns is selected for audit at random. Generating revenue is not the direct purpose of these audits. Rather, random audits are used primarily to gather information.²³ The information gathered is used to create and update the DIF which, as described above, permits the IRS to use its limited audit resources more effectively; to determine whether IRS approaches to encouraging compliance, such as improved guidance for taxpayers, are effective; and to estimate the total gap between tax revenue that should have been collected and tax revenue actually collected (commonly known as the "tax gap").²⁴

These information-gathering random audits began, under the name "Taxpayer Compliance Measurement Program," or "TCMP," in the 1960s, and were repeated every three years until 1988. Each TCMP audit examined a relatively small number—less than 100,000—of randomly selected returns of individuals. A TCMP audit took about twice as long as a regular audit, and involved not only a line-by-line review of each

¹⁹ *Id.*

²⁰ For example, in 1992, the IRS selected between fifty-five percent and fifty-nine percent of individual returns audited using the DIF. *Id.* ("The DIF rate for individual returns in 1992 was 59 percent, according to the IRS."); U.S. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: ALTERNATIVE STRATEGIES TO OBTAIN COMPLIANCE DATA 6 (1996) [hereinafter ALTERNATIVE STRATEGIES] (stating that the DIF rate in 1992 was "over 55 percent" of individual returns). In 1994, because the IRS chose to use its resources on a project targeting nonfilers, only twenty-one percent of individual returns audited were selected using the DIF. See Guttman, *supra* note 17 (attributing the drop in audited individual returns in 1993 and 1994 to a nonfiler initiative).

²¹ Correspondence audits rely solely on written correspondence between the IRS and the taxpayer. These audits are limited to situations in which all information required to resolve the audit can be "easily submitted by mail." INTERNAL REVENUE MANUAL § 4.19.11.1.3(9) (2007). Issues that might be resolved through a correspondence audit include verification of medical and dental expenses or other easy-to-verify deductions such as real estate or state taxes paid. *Id.*

²² IRS' RETURN SELECTION PROCESS, *supra* note 11, at 3.

²³ ALTERNATIVE STRATEGIES, *supra* note 20, at 2.

²⁴ *Id.* (describing the purposes of TCMP audits); IRS, Privacy Impact Assessment—National Research Program, <http://www.irs.gov/privacy/article/0,,id=139179,00.html> (describing the purpose of NRP audits, which is the same as the purpose of TCMP audits) (last visited July 10, 2008).

taxpayer's return, but also substantiation for all the information on the taxpayer's return.²⁵ Another TCMP was scheduled for the 1994 tax year, but the study was postponed in response to anti-IRS political pressure, and then was cancelled in 1995 after Congress significantly reduced the IRS budget.²⁶ In 2002, the IRS began its National Research Program, or "NRP." Like the TCMP, the NRP selects returns randomly, but it reviews even fewer returns and does so with less intensity than the TCMP.²⁷ A new NRP compliance study began in October 2007.²⁸

Although relatively few taxpayers are selected for random audits, random audits are key to IRS enforcement. The importance of these audits lies in their very randomness, because it is this randomness that permits the IRS to gather accurate information. Indeed, one statistician has described these random audits as "an irreplaceable technique for understanding a whole host of economic and tax compliance issues."²⁹ Because the audits that gather information for the DIF are random, the DIF can be structured to pick out returns to audit that have a higher probability of resulting in a significant tax change.³⁰ This selection can be performed without distorting future audits, because enforcement results are not used to change the DIF; rather, only data gathered from the random audits move the DIF.³¹

²⁵ See Press Release, IRS, IRS Moves to Ensure Fairness of Tax System; Research Program Works to Increase Compliance Program Effectiveness, Reduce Burdens on Taxpayers (Jan. 16, 2002), available at <http://www.irs.gov/pub/irs-news/ir-02-05.pdf> [hereinafter Press Release, IRS Moves to Ensure Fairness] (explaining that the IRS is moving away from the time-intensive audits and putting the burden on itself).

²⁶ The study would have reviewed over 150,000 individual returns. George Guttman, *Citing Budget, IRS Announces Indefinite Suspension of TCMP*, 95 TAX NOTES TODAY 212-25, Oct. 30, 1995, available at LEXIS, News Library, TNT File. For example, Newt Gingrich, House Speaker at the time, referred to the TCMP as "a little bit like the return of the Inquisition," and said that it was used by the IRS simply to persecute randomly selected taxpayers. *Id.*; see also *infra* text accompanying note 106 (discussing the effect on compliance of perceived retributive injustice).

²⁷ Under the NRP, the IRS audited about 46,000 individual tax returns from the 2001 tax year, completing the audits in 2005. Press Release, IRS, IRS Updates Tax Gap Estimates (Feb. 14, 2006), available at <http://www.irs.gov/pub/irs-news/ir-06-028.pdf>. The majority of those audits involved a "focus only on select parts of approximately 30,000 returns," and only "about 2,000 audits" were line-by-line audits. Press Release, IRS Moves to Ensure Fairness, *supra* note 25. Furthermore, an NRP audit, unlike a TCMP audit, does not require substantiation for each line of a tax return, even in the line-by-line audits. *Id.*

²⁸ Unlike the prior surveys, the new NRP is multi-year, and will examine about 13,000 individual tax returns for each taxable year, starting with returns for the 2006 taxable year. Press Release, I.R.S. Media Relations Office, IRS Updates National Research Program for Individuals (June 6, 2007), available at <http://www.irs.gov/pub/irs-news/ir-07-113.pdf>. While most individuals selected for the NRP will have in-person meetings with IRS auditors to confirm specific lines of their returns, individuals whose returns can be fully verified via third-party reporting and matching will not even be contacted by the IRS, and may not even know they were part of the NRP. *Id.*

²⁹ Fritz Scheuren, *GWU Professor's Testimony at W&M Oversight Hearing on TCMP*, 95 TAX NOTES TODAY 140-47, July 19, 1995, available at LEXIS, News Library, TNT File.

³⁰ This assumes the sample of taxpayers is sufficiently large and is well designed, which appears to be at least roughly the case; one statistician who helped design the TCMP believes that the sample design work is of "an exceedingly high calibre." *Id.*

³¹ Cf. BERNARD E. HARCOURT, *AGAINST PREDICTION: PROFILING, POLICING, AND PUNISHING IN AN ACTUARIAL AGE* 145-72 (2007) (describing how adjusting enforcement programs based on non-

Additionally, random audits allow the IRS to avoid channeling its enforcement resources based entirely on its preconceptions.³² In short, while relatively few taxpayers are picked for audit randomly, random audits provide information that is essential to tax enforcement.

B. *The Compensation Proposal: Begging the Unfairness Question*

During Congress's anti-IRS campaign of the 1990s, random audits came under attack. Prominent politicians and lobbyists claimed that subjecting a random group of taxpayers to such a costly process was unfair. Senator Mike Enzi referred to random audits as an "abomination" and said that random audits were not legitimate.³³ Senator Paul Coverdell proposed banning random audits because they were unfair.³⁴ And the president of the National Taxpayers Union stated before the Ways and Means Oversight Committee that it was "patently unfair to put a random group of taxpayers through the rigorous, sometimes ridiculous and very expensive process that TCMP entails for statistical purposes."³⁵

In response to the claim that imposing these costs randomly is unfair, some have suggested that taxpayers who are selected for these random audits should be financially compensated for their audit costs.³⁶ For example, Representative Nancy Johnson said that such taxpayers should be reimbursed for their troubles in part because, as she explained, "the audits are seen as unfair for those whose returns show no indication of a need for an audit."³⁷ Similarly, from the academic side, Joseph Bankman has argued that randomly imposed audits provide "probably the strongest case for government reimbursement of compliance costs" because such audits are thought to be "unfair and/or politically unsustainable A generous reimbursement system . . . might resolve the fairness and political issues that have dogged that program."³⁸ He argues that random audits "unfairly

random sampling can lead to a "ratchet effect" in which profiled characteristics increasingly define the offending group); Bernard E. Harcourt, *The Shaping of Chance: Actuarial Models and Criminal Profiling at the Turn of the Twenty-First Century*, 70 U. CHI. L. REV. 105, 124–25 (2003) (same).

³² See, e.g., Guttman, *supra* note 1 ("Malcolm Sparrow, an IRS consultant and expert on compliance matters with Harvard's John F. Kennedy School of Government, argues that TCMP is vital because it can detect patterns of noncompliance that the Service might otherwise not notice. According to Sparrow, the strength of TCMP is in its random selection.").

³³ *Senators Blast IRS*, 98 TAX NOTES TODAY 89–86, May 8, 1998, available at LEXIS, News Library, TNT File (reprinting Senator Mike Enzi's remarks on the Senate floor).

³⁴ 144 CONG. REC. S3791 (daily ed. Apr. 29, 1998) (introducing the Internal Revenue Service Random Audit Prohibition Act).

³⁵ Keating, *supra* note 1.

³⁶ See, e.g., Guttman, *supra* note 1 ("Some have proposed reimbursing taxpayers for the added burdens brought by a TCMP audit."); Keating, *supra* note 1 ("[T]he government should be required to compensate . . . taxpayers.").

³⁷ Donmoyer, *supra* note 1 (quoting Representative Johnson).

³⁸ Bankman, *Who Should Bear Tax Compliance Costs?*, *supra* note 1, at 3; see also *id.* ("[S]ome compliance costs fall disproportionately upon a small group of taxpayers. A rule that shifted these costs to the government might comport with some notions of fairness."); *id.* at 17 ("The costs of running a

concentrate costs on a small handful of taxpayers, who were randomly chosen to perform a subsidized public service for other taxpayers.”³⁹

Although it is difficult to quantify the costs that random audits, like all audits, impose on taxpayers,⁴⁰ there are at least three kinds of costs a taxpayer might bear due to an audit, random or otherwise: direct financial costs, opportunity costs, and emotional costs. First, audits may directly cost a taxpayer, even an honest taxpayer, money—that is, the taxpayer may have to expend money, as distinguished from using time for the audit that he otherwise would have used to earn money. As a result, the taxpayer may wish to retain an accountant to help him make sense of his finances, or a lawyer or other agent to represent him before the IRS.⁴¹

Second, audits may cost a taxpayer time because he may have to gather and review documents for an auditor, or sit with an auditor while the auditor reviews documents and questions the taxpayer. This is likely time the taxpayer would prefer to spend on another activity, or time the taxpayer could have spent earning money.

Finally, even a taxpayer who believes that he has fully complied with the tax law may suffer emotional distress because of the audit. Perhaps he fears that even though he has done nothing wrong, the IRS will make a mistake and demand more money from him; perhaps he is disturbed by the government’s searching through his financial records, or by the presence of a representative of the government in his home; perhaps he feels ashamed that he is being audited; or perhaps he suffers emotional distress from the audit for some other reason personal to that taxpayer.

Compensating taxpayers for their audit costs might have advantages. For example, forcing the government to internalize more compliance costs might cause the government to create more efficient rules and procedures and to calibrate marginal costs and benefits more accurately.⁴² The

reimbursement program include the costs of reimbursement and the costs of administering the program. Both costs would presumably be funded through a . . . conventional income tax. This might be fairer than the . . . present system, which, as noted above, is to some extent haphazard in its incidence.”); *id.* at 23 (“[T]he existing [audit cost] burden acts as an unfairly levied de facto penalty.”).

³⁹ *Id.* at 6.

⁴⁰ The IRS Restructuring and Reform Act of 1998 required the IRS to quantify pre- and post-filing burdens, but the IRS has not yet managed to provide any numbers for post-filing burdens. As of May 2000, the IRS had not designed a model to determine post-filing burdens, and in fact did not even have the data that would permit it to design such a model. See U.S. GEN. ACCOUNTING OFF., TAX ADMINISTRATION: IRS IS WORKING TO IMPROVE ITS ESTIMATES OF COMPLIANCE BURDEN 13 (2000) (reporting that, in 2000, decisions still needed to be made regarding the model). As of February 2004, the IRS apparently still had made no headway on the project. Rojas, *supra* note 1 (referring to pre- and post-filing burdens as a future tool). I have been able to locate no mention since then of such a project.

⁴¹ One medium-sized accounting firm has estimated that it would charge a high-income taxpayer in the New York City area who was selected for a random audit “[a]nywhere from \$2,500 to \$25,000” for audit-related representation. Tom Herman, *The Next Audit Scare*, WALL ST. J., June 13, 2007, at D1, available at LEXIS, News Library, WSJNL File (quoting David Lifson, Partner, Hays & Co.).

⁴² E.g., DAVID CAY JOHNSTON, PERFECTLY LEGAL 316–17 (2003) (suggesting that “[t]o protect taxpayers from zealous IRS agents,” a taxpayer who is audited should “get a payment from the

proposal also has drawbacks, or at least potential difficulties. For example, if only honest taxpayers were compensated for audit costs, the IRS would have an even greater incentive to find something wrong on every return it examined.⁴³ On the other hand, compensating all taxpayers for the costs of randomly imposed audits would weaken any deterrence that penalties currently provide and thus might lessen tax compliance.⁴⁴

If taxpayers should be compensated for randomly imposed audit costs, all these difficulties, and others, would have to be addressed. But before we reach these questions, which are essentially questions of implementation, more fundamental issues must be addressed. In particular, the compensation proposal, to the extent it is motivated by the desire to mitigate unfairness, begs some basic questions: are randomly imposed audit costs in fact unfair? And if randomly imposed audit costs are unfair, should financial compensation be used to mitigate this unfairness? This Article answers these questions.

III. ARE UNCOMPENSATED RANDOM AUDIT COSTS UNFAIR?

This Part examines fairness from an ex ante and ex post perspective. From a pure ex ante perspective, randomly imposing audit costs and not compensating taxpayers for these costs is fair. From an ex post perspective, such random costs at first appear unfair. This Part argues, however, that because taxpayers may choose to buy insurance against ex post inequality, randomly imposing audit costs, and not compensating individuals for these costs, is also fair from an ex post perspective.⁴⁵

government, say \$100, for her trouble if her tax return was flawless, and a 10 percent bonus on any additional refund"); Bankman, *Who Should Bear Tax Compliance Costs?*, *supra* note 1, at 13 ("A rule that reimburses taxpayers for compliance costs will avoid the externalization of costs by the government to taxpayers but lead to externalization of taxpayer costs to the government. The government will have an incentive to minimize costs within its control."). Senator Phil Gramm said that he "think[s] [compensating taxpayers for random audits] will be a check on the IRS in terms of when to cut bait on some of these lawsuits, if, in fact, you force [the IRS] to pay the cost." *Full Text: Unofficial Transcript of Finance Committee Hearing on IRS Reform*, 98 TAX NOTES TODAY 25-31, Feb. 6, 1998, available at LEXIS, News Library, TNT File; see also Keating, *supra* note 1 (arguing for compensating taxpayers for TCMP costs because under the current system, "the IRS has little incentive to make the process more efficient because it has ignored the value of taxpayers' time and expense").

⁴³ See, e.g., Keating, *supra* note 1 ("While some may argue that taxpayers whose exams render a sizable deficiency and substantial non-compliance should bear the cost of their examinations, this will only serve to encourage some at the IRS to assume overly aggressive positions with respect to potential adjustments."). This problem might be addressed by having a sliding scale for reimbursement, or requiring the IRS to pay out a certain amount of compliance compensation each audit cycle. Bankman, *Who Should Bear Tax Compliance Costs?*, *supra* note 1, at 22-23.

⁴⁴ See, e.g., Bankman, *Who Should Bear Tax Compliance Costs?*, *supra* note 1, at 22 ("It might [seem] inapposite to reimburse compliance costs for those who seem likely to, and in fact do, underreport their income taxes.").

⁴⁵ Even those who believe overall welfare is an important evaluative principle may accept that fairness could be independently relevant. See, e.g., MATTHEW D. ADLER & ERIC A. POSNER, *NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS* 52-61 (2006) (advocating as a decision principle "weak

A. *What Is Fair?*

What does it mean to claim that it is actually unfair to impose audit costs randomly and not to compensate audited taxpayers for these costs—that is, to impose costs randomly on certain citizens for the good of the whole?⁴⁶ In other words, what does “fairness” mean in this context?

We could view the process of allocating random audits as a process for randomly selecting individuals to escape audit. In other words, if audits are required in order to enforce tax law effectively, “not being audited” can be seen as a scarce good that must be allocated among taxpayers. That is, there is not enough “nonauditing” to go around, because some people must be audited.⁴⁷ All taxpayers are in the same position *ex ante*—everyone can expect to bear the same audit cost, weighted by the probability of audit—but those selected for audit end up, *ex post*, worse off than those not selected.⁴⁸

Viewed from a pure *ex ante* perspective, randomly distributing audit costs is fair. When audits, and thus audit costs, are imposed randomly, all taxpayers have an equal chance of being selected for audit, and the individual qualities of each taxpayer are irrelevant. In other words, such an audit lottery is equiprobable and impersonal,⁴⁹ and treats all taxpayers as equals.⁵⁰ Moreover, no other mechanism (such as adjudication) is available; as discussed above, given the government’s limited resources, which make auditing everyone impossible, some audits must be imposed randomly if tax enforcement is to be effective.⁵¹ Under these

welfarism,” which takes as relevant some set of considerations $\{W, F_1, F_2 \dots F_m\}$, where W is overall welfare and the set of F_i are other considerations, which “might include an egalitarian factor”).

⁴⁶ Nonrandom audits also raise their own questions of fairness—questions outside the scope of this Article. For example, is it unfair to impose costs on certain citizens for the good of the whole because they have certain characteristics that suggest, based on statistical models, that they are more likely than the general population to have disobeyed the law (i.e., to use DIF scores to select individuals for audit)? And is it unfair to impose costs on certain citizens for the good of the whole because they have one characteristic that may or may not suggest that they are more likely than the general population to have disobeyed the law (i.e., to audit an individual as part of an IRS special project)?

⁴⁷ Recall that while the government is imposing costs on some, but not all, taxpayers, the costs are not punitive—that is, the costs are not intended to punish. The government does not assume culpability. The truly random audits, in particular, do not even have raising revenue or enforcement as their immediate purpose. Indeed, some have suggested that individuals who are picked randomly to be audited as part of TCMP (now NRP) audits should not be subject to any upward adjustment of their taxes, regardless of what the audit reveals. Rather, as discussed *supra* in notes 23–32 and accompanying text, random audits are primarily information-gathering projects that permit the IRS to develop the DIF score, which in turn permits the IRS to (try to) focus its audit resources on individuals who are more likely to have failed to comply with the tax law.

⁴⁸ See Barbara H. Fried, *Ex Ante/Ex Post*, 13 J. CONTEMP. LEGAL ISSUES 123, 124 (2003) (noting both welfarists and egalitarians may be committed to a strong *ex ante* justice position).

⁴⁹ Lewis A. Kornhauser & Lawrence G. Sager, *Just Lotteries*, 27 SOC. SCI. INFO. 483, 485 (1988) (explaining that a fair lottery is inherently defined by its “equiprobability” and “impersonality”).

⁵⁰ See *id.* at 502 (noting that a fair lottery “is indifferent and hence neutral among the members of the lottery pool”).

⁵¹ See *supra* notes 29–32 and accompanying text.

circumstances, if our commitment is to treating taxpayers as equals *ex ante*, random audits are both fair and just.⁵²

It may initially seem that from an *ex post* perspective, randomly imposed audits are unfair because they impose burdens on some people, but not others, for no reason. The government, in other words, is not treating “likes alike.” Some people must bear the burden of audit costs; others escape those costs; and there is no principled way to distinguish among these people. This seems, in a general sense, unfair.

But *ex ante* and *ex post* concerns can be blended by linking outcomes with the ability to avoid these outcomes. Some philosophers, called luck egalitarians, have argued that individuals should bear the consequences of risk unless that risk was unavoidable.⁵³ If an individual is personally responsible for putting himself in the risky position, then he should bear any negative outcome of the risk. This is Ronald Dworkin’s “option luck”—luck related to “deliberate and calculated gambles.” If, on the other hand, he could not avoid the risk, then it is fair to compensate him.⁵⁴ This is “brute luck”—such as being “hit by a falling meteorite.”⁵⁵ In other words, a person should bear the consequences of his choices, and thus should not be compensated for bad option luck, but should be compensated for bad brute luck, which is not the result of any choice he made. Essentially, if unavoidable risk harms some, but not all, individuals, those who are harmed should be compensated.

Being randomly selected for a tax audit is more an effect of brute luck than of option luck. Most taxpayers who earn enough money to support

⁵² See Kornhauser & Sager, *supra* note 49, at 510 (“Lotteries . . . [do] justice among equally entitled claimants.”). Randomness has been proposed as a useful decision process in other areas because it treats all parties the same *ex ante* and thus is more fair than other available methods of decisionmaking. See, e.g., Michael J. Pitts, *Heads or Tails? A Modest Proposal for Deciding Close Elections*, 39 CONN. L. REV. 739, 741–42 (2006) (proposing that close elections be decided randomly, because a coin flip would seem more fair than permitting judges or other public officials to decide close elections); Akhil Reed Amar, Note, *Choosing Representatives by Lottery Voting*, 93 YALE L.J. 1283 (1984) (proposing a method of election in which, instead of electing the candidate who receives the most votes, a “single ballot is randomly drawn [from the pool of all ballots cast], and the candidate chosen in that ballot wins the election”). Intriguingly, these “proposals” are generally not meant seriously, and are disclaimed by their authors as “modest proposal[s],” Pitts, *supra*, 742, 755, or “thought experiment[s],” Amar, *supra*, at 1283.

⁵³ For scholarship that uses egalitarianism to analyze tax policy, see generally Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 476–85 (2007) (discussing Ronald Dworkin’s equality of resources approach); Anne L. Alstott, *Work vs. Freedom: A Liberal Challenge to Employment Subsidies*, 108 YALE L.J. 967 (1999) (questioning employment subsidies in an egalitarian framework); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994) (arguing for comprehensive tax reform); Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363 (1996) (responding to Professor McCaffery’s egalitarian analysis).

⁵⁴ See Fried, *supra* note 48, at 133–34 (discussing Dworkin’s concept of brute luck).

⁵⁵ Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283, 293 (1981).

themselves are required to file tax returns.⁵⁶ And even if a taxpayer earns so little money that he is not required to file a tax return, his income will probably be reported to the IRS by the person who pays him.⁵⁷ Additionally, low-income taxpayers must file a return in order to obtain what are essentially welfare benefits in the form of the earned income tax credit.⁵⁸ Earning enough money to survive, or obtaining help from the government if one does not earn enough money, should not in itself be considered a risky choice, and a taxpayer should not be required to bear the possible negative consequences of that choice in Dworkin's scheme.⁵⁹

However, as Dworkin points out, the gap between brute luck and option luck can be bridged. If insurance against a possible (brute bad luck) event is available, then there is no reason to compensate an individual who chooses not to purchase that insurance and is subsequently visited by brute bad luck. Dworkin gives the example of two individuals who are both blinded in the same accident. If blindness insurance was available, and one individual chose to purchase it and one did not, there is no reason, Dworkin argues, to redistribute resources from the insured to the uninsured; both have had brute bad luck, but any difference between them is a matter of option luck. Similarly, if the uninsured individual is the only

⁵⁶ The general rule is that all individuals with gross income at least equal to the exemption amount (\$3400 in 2007) must file a return. I.R.C. § 6012(a); IRS, Publication 501—Introductory Material, <http://www.irs.gov/publications/p501/ar01.html> (last visited June 24, 2008). However, this general rule is largely swallowed by its exceptions, which permit certain taxpayers to add one or more standard deductions to the cut-off amount. For example, an unmarried individual need not file a tax return if he is neither a surviving spouse nor a head of a household, and his annual gross income is less than the exemption amount plus the standard deduction. I.R.C. § 6012(a)(1)(A)(i). In 2007, the cut-off for such a taxpayer was \$8750. IRS, Publication 501—Introductory Material, <http://www.irs.gov/publications/p501/ar01.html> (last visited June 24, 2008). The poverty line in 2007 for an individual under 65 was \$10,787. U.S. Census Bureau, Housing and Household Economic Statistics Division, Poverty Thresholds 2007, <http://www.census.gov/hhes/www/poverty/threshld/thresh07.html> (last visited June 17, 2008).

⁵⁷ The person who pays him will be required to report these payments regardless of whether he is an employee or an independent contractor for tax purposes.

⁵⁸ IRS, Do You Qualify for the Earned Income Tax Credit?, <http://www.irs.gov/newsroom/article/0,,id=153996,00.html> (last visited June 24, 2008). Interestingly, taxpayers who file for the EITC are more likely, not less likely, to face audits, as compared with taxpayers who have not applied for that credit. This is so because auditing taxpayers who claim the EITC has been an IRS project. For more information about the IRS EITC project see *supra* text accompanying notes 10–12. See also IRS' USE OF RANDOM SELECTION, *supra* note 12, at 2–3, 8 (reporting findings of IRS projects, including the earned income credit).

⁵⁹ See, e.g., Martin E. Sandbu, *On Dworkin's Brute-Luck-Option-Luck Distinction and the Consistency of Brute-Luck Egalitarianism*, 3 POL., PHIL. & ECON. 283, 294–99 (2004) (discussing the "reasonability" refinement of Dworkin's theory, that is, that "if the riskless prospect is unreasonable, then brute luck is only converted into option luck in so far as the least risky *reasonable* prospect provides insurance"). This discussion is not meant to suggest that all who earn a minimum amount of money file tax returns or are somehow reported to the IRS. Some people are entirely "off the books." See generally SUDHIR ALLADI VENKATESH, *OFF THE BOOKS: THE UNDERGROUND ECONOMY OF THE URBAN POOR* (2006). This discussion is simply meant to suggest that all else being equal, it seems highly unlikely, and highly unreasonable, that an individual would choose to remove himself entirely from the tax system in an attempt to avoid random audit costs alone (as opposed to removing oneself from government oversight in an attempt to avoid taxes or regulation).

one blinded, there is no reason to redistribute resources to him.⁶⁰ As Dworkin states, “[I]f everyone had an equal risk of suffering some catastrophe that would leave him or her handicapped, and everyone knew roughly what the odds were and had ample opportunity to insure—then handicaps would pose no special problem for equality of resources.”⁶¹

While being randomly picked to bear audit costs may be brute bad luck, if it is possible to insure against these costs, there is not necessarily any fairness-based reason to compensate individuals for audit costs. Moreover, the luck egalitarian is not posing the empirical question of whether the market has actually provided insurance. Rather, the luck egalitarian poses the question of whether the market is able to provide insurance to the extent that people want that insurance. If people do not want insurance against random audit costs, the government need not—indeed, should not—compensate people for the costs of random audits, because government compensation is essentially forced insurance. If, on the other hand, people do want such insurance, and the market is not able to provide that insurance for some reason, then the government should step in.⁶²

From an *ex ante* perspective, randomly imposing audit costs is fair. From an *ex post* perspective, randomly imposing audit costs without compensation is also fair, if insurance against these costs is available. As the next Part discusses, such insurance is in fact available for most taxpayers, and therefore not compensating these taxpayers for random audit costs is fair.

B. *Audit Insurance*

As this Part describes, research into the world of commercial tax preparers and insurers demonstrates that a market for audit insurance exists, and therefore luck egalitarianism would not generally require the government to compensate individuals for randomly imposed audit costs. However, fairness may require the government to compensate randomly audited individuals, in particular low-income taxpayers, for whom the audit insurance market has failed.

1. *The Market for Audit Insurance*

Taxpayers can in fact purchase insurance against audit costs. H&R Block, the most frequently used paid tax preparer, and TurboTax, the most

⁶⁰ Dworkin, *supra* note 55, at 296–97.

⁶¹ *Id.* at 297. There is a different outcome if the risk of catastrophe is not equally (randomly) distributed among individuals. *Id.*

⁶² *Cf.* Fried, *supra* note 48, at 130 (noting that from a welfarist perspective, government compensation for losses may increase overall welfare if investors want insurance but the market cannot provide it, but also noting that this increase in welfare may be offset by the costs of government intervention, and thus such compensation may provide no net gain in welfare).

frequently used electronic tax preparer, both offer audit insurance for a relatively small additional fee.⁶³ This insurance seems to be intended for the risk-averse taxpayer; as H&R Block explains:

Q. Who should use H&R Block Peace of Mind[®]?

A. Those clients who want no surprises after filing their taxes. It's a smart way to make sure you're covered no matter how complex your tax situation. The benefits of the Peace of Mind[®] Extended Service plan will be invaluable in the event that you . . . need representation because the IRS questions your tax return.⁶⁴

The advertising for TurboTax's audit insurance, provided in affiliation with TaxResources Incorporated, seems to play on the relief that the audit insurance will bring from having to deal with the IRS:

TaxResources will professionally defend you in an income tax audit for any tax year for which you have purchased a membership. This includes all communications and meetings with the IRS or state taxing agency, from receipt of the first notice to completion of the audit. TaxResources will defend you throughout the entire audit process *You never meet with the IRS!*⁶⁵

In other words, TurboTax suggests that its coverage will even relieve the taxpayer of nonmonetary costs, because TaxResources will interact

⁶³ H&R Block, Peace of Mind[®] Extended Service Plan, http://www.hrblock.com/taxes/doing_my_taxes/products/popup/pop_pom_features.html (last visited June 22, 2008) (offering, for thirty dollars, an "extended service plan" under which, for no additional fee, an H&R Block agent represents the taxpayer if the taxpayer is audited); Turbo Tax, Product List, <https://secureportal.taxaudit.com/intuit/SpecialPrograms/CompleteProductListJoinNow.aspx?pc=A> (last visited June 22, 2008) (offering, for \$39.95, a plan under which, for no additional fee, TurboTax provides a representative for the taxpayer if the taxpayer is audited); TurboTax, Audit Defense Membership Agreement, <http://turbotax.intuit.com/corp/auditdefense.jhtml> (last visited June 22, 2008) (describing the Tax Audit Defense plan). The majority of taxpayers use a paid preparer. For example, out of approximately 134,000,000 individual returns filed for the 2005 tax year, approximately 80,000,000, or 60%, were prepared by a paid preparer. IRS, 2005 ESTIMATED DATA LINE COUNTS INDIVIDUAL INCOME TAX RETURNS, available at <http://www.irs.gov/pub/irs-soi/2005linecnt.pdf>. H&R Block generally prepares close to 16% of U.S. individual tax returns filed each year. H&R BLOCK INC., FORM 10-K 6 (2007), available at <http://ccbn10kwizard.com/xml/download.php?repo=tenk&ipage=5023553&format=PDF> (reporting filing 15.6% of U.S. tax returns for tax year 2004; 15.7% for tax year 2005; and 16.1% for tax year 2006). TurboTax sold about thirteen million programs, either software packages or on-line returns, for tax year 2006, so it probably accounted for slightly less than 10% of returns filed that year. Historical TurboTax Unit Sales Data, http://http-download.intuit.com/http.intuit/CMO/intuit/investors/TurboTax_historical_data_for_release.pdf (last visited May 5, 2008).

⁶⁴ H&R Block, Peace of Mind Extended Service Plan, http://www.hrblock.com/taxes/doing_my_taxes/products/popup/pop_pom_features.html (last visited June 24, 2008).

⁶⁵ Turbo Tax, What is Tax Audit Defense?, <https://secureportal.taxaudit.com/intuit/StaticContent.aspx?scf=SpecialPrograms/WhatIsTaxAuditDefense.htm> (last visited June 24, 2008) (emphasis in original).

with the IRS on the taxpayer's behalf, thus largely eliminating the discomfort—the emotional costs—that the experience of an audit may impose on a taxpayer.

TurboTax also includes, in its description of the “eight types of audits” that a taxpayer might face, a paragraph on random audits, which it describes as follows:

In order to improve the IRS's audit selection process, the IRS randomly selects individual tax returns for audit. This audit plan, called the National Research Program[,] is the successor to the Taxpayer Compliance Measurement Program (TCMP). This audit is certainly the most intrusive by its very nature. Every entry on the tax return can be examined, line by line. For instance, if a child was claimed as a dependent, you will need to provide the birth certificate to prove that the child is yours and proof that the child was actually living with you in the tax year being audited. The IRS is currently performing these audits nationwide.⁶⁶

Jackson Hewitt, the second-largest tax return preparer,⁶⁷ takes a slightly different approach. Instead of offering full audit representation for an extra fee, Jackson Hewitt claims to offer, as one Jackson Hewitt franchisee explains, “free audit assistance to customers who receive an audit notice from the IRS. In fact, our offices provide free tax advice and audit assistance year-round, regardless of the Jackson Hewitt location in which the taxpayer's return was prepared.”⁶⁸

Therefore, if a taxpayer chooses to have his return prepared by H&R Block or to use the TurboTax program, he has the opportunity to purchase audit cost insurance. A taxpayer who has his return prepared by Jackson Hewitt apparently does not have to pay anything extra for audit cost insurance.

Individuals who do not use these preparers might also be able to obtain audit cost insurance. A wealthier taxpayer who has his own private tax preparer and wants to purchase insurance separately might be able to purchase insurance against audit costs directly from an insurance company. Some corporations currently buy insurance to protect themselves from bad substantive tax results (for example, the IRS's ruling that a transaction is

⁶⁶ TurboTax, The Eight Types of Audits, <https://secureportal.taxaudit.com/intuit/StaticContent.aspx?scf=StandardContent/EightTypesOfAudits.htm> (last visited June 24, 2008) (emphasis deleted).

⁶⁷ Jackson Hewitt Tax Serv. Inc., Annual Report (Form 10-K), at 2 (June 29, 2007), *available at* <http://www.secinfo.com/d14D5a.u4FSm.htm> [hereinafter JACKSON HEWITT 2007 10-K]. Jackson Hewitt prepares about 2.4% of the individual tax returns filed each year. *Id.* (“In 2007, our network . . . prepared 3.65 million tax returns. We estimate our network prepared approximately 4% of all tax returns prepared by a paid tax return preparer.”).

⁶⁸ C K Ventures, Inc., Products & Services, <http://www.ckventuresinc.com/products.html> (last visited June 24, 2008).

not tax-free, and the pricing of that insurance is presumably based, in part, on the probability that the substantive behavior will be detected). In these instances, the corporation will be audited.⁶⁹ Proceeds of the policies may be used in part to pay for audit costs. Some high-net-worth individuals also purchase tax insurance.⁷⁰ If such an individual were concerned about audit costs, he could likely find an insurance company willing to write a policy, probably for a very low premium.⁷¹ Finally, in some states, taxpayers may purchase prepaid legal services that, while not technically insurance, include audit representation for no additional fee.⁷²

Thus, because audit insurance appears to be available for those who wish to purchase it, fairness does not generally require the government to compensate taxpayers for their audit costs.

2. *When the Market Fails*

There may, however, be an exception to the general rule that fairness does not require the government to compensate taxpayers for randomly imposed audit costs: fairness may require the government to compensate individuals who do not have access to insurance against random audit costs. In particular, if low-income individuals do not have access to effective audit insurance, fairness requires the government to reimburse them for their audit costs.

For example, Jackson Hewitt markets itself to low-income taxpayers. As Jackson Hewitt itself explains, its customers generally file early in the tax season, in order to avail themselves of tax refunds, and generally have lower adjusted gross incomes than taxpayers who file later in the season and do not need the money from their tax refunds.⁷³ While slightly more than half of those filing tax returns in the United States have adjusted gross income of less than \$35,000, more than seventy-five percent of Jackson Hewitt customers fall within this income range.⁷⁴

Imagine that the audit cost insurance that Jackson Hewitt bundles with

⁶⁹ See generally Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Law Insurance*, 25 VA. TAX REV. 339 (2005). There is some debate about whether such insurance should be allowed, because it may be undesirable to allow corporations to shift the risk of engaging in bad tax behavior, such as tax shelters. *Id.* at 395–400.

⁷⁰ Lee A. Sheppard, *News Analysis: Economic Substance Comes to Estate Planning*, 2004 TAX NOTES TODAY 105-2, June 1, 2004, available at LEXIS, News Library, TNT File.

⁷¹ Premia for substantial tax insurance policies are generally extremely low. Kenneth A. Gary, *New Opportunity for Tax Lawyers: Insuring Tax Transactions*, 2004 TAX NOTES TODAY 130-8, July 7, 2004, available at LEXIS, News Library, TNT File. Given the low probability of being randomly selected for audit and the relatively low cost of audit, insuring against randomly imposed audit costs should also cost very little.

⁷² Pre-Paid Legal Services, Inc., http://www.ceai.org/fbenefits/prepaid_legal/prepaid_legal_services.htm (last visited July 28, 2008). In some states (New York, for example), Pre-Paid Legal Services' audit representation requires additional payments on top of the flat fee.

⁷³ JACKSON HEWITT 2007 10-K, *supra* note 67, at 2.

⁷⁴ *Id.*

its general tax preparation package is sometimes ineffective. This might not be far from the truth. The Better Business Bureau lists a number of Jackson Hewitt franchises with unsatisfactory records due to failure to respond to complaints regarding guarantee issues.⁷⁵ And at least two class action lawsuits have been filed against Jackson Hewitt alleging, among other claims, that it regularly urges taxpayers for whom it has prepared fraudulent returns to purchase audit insurance in the form of its “Gold Guarantee,” and then refuses to honor the guarantee.⁷⁶ One lawsuit was dismissed without prejudice;⁷⁷ as of May 2008, the other was still pending.⁷⁸ In other words, it is possible that at least some Jackson Hewitt franchises do not provide effective representation—or perhaps any representation—before the IRS.

It is also possible that low-income taxpayers who use Jackson Hewitt would be unable to switch to H&R Block or another tax preparer who would offer audit insurance if, for example, the only tax preparation “shop” in the neighborhood is Jackson Hewitt. Some of these taxpayers might pay someone else—perhaps a neighbor—to prepare their taxes,⁷⁹ but it seems likely that the neighbor would not be in a position to offer effective audit cost insurance.

It seems highly unlikely that a low-income taxpayer would be able to purchase a free-standing audit cost policy from an insurer. Perhaps this is because low-income taxpayers are not well-informed about the possibility of insurance, or perhaps it is because insurance companies have no interest in marketing tax insurance to individuals who would, if audit insurance were priced fairly, pay only minimal premiums and have little or no use for more expensive tax insurance policies. For example, low-income taxpayers will probably not be engaging in sophisticated estate planning.⁸⁰ Thus, if low-income individuals who want audit cost insurance are not able to obtain it because the market will not provide it, fairness requires the

⁷⁵ Better Business Bureau, <http://us.bbb.org> (follow hyperlink “Check Out a Business or Charity”, search for “Jackson Hewitt”) (last searched Sept. 17, 2008).

⁷⁶ Complaint, *Chapman v. Jackson Hewitt Inc.*, No. 07-2910, D.N.J. (filed June 22, 2007); Complaint, *Wooley v. Jackson Hewitt Inc.*, 540 F. Supp. 2d 964 (N.D. Ill. 2008).

⁷⁷ JACKSON HEWITT TAX SERV. INC., FORM 10-Q 14 (2007), available at <http://investing.businessweek.com/research/stocks/financials/drawFiling.asp?docKey=137-000119312507261476-6Q09DHILLI5V8UV4B7SRO45JGD&docFormat=HTM&formType=10-Q> (stating that a joint stipulation of dismissal without prejudice was approved by the court in *Chapman v. Jackson Hewitt Inc.* on October 31, 2007).

⁷⁸ JACKSON HEWITT TAX SERV. INC., FORM 10-Q 14 (2008), available at <http://investing.businessweek.com/research/stocks/financials/drawFiling.asp?docKey=137-000119312508051728-55B6314JGBFA63BRLV41SCSSQP&docFormat=HTM&formType=10-Q> (stating that a decision by the court on a motion to dismiss *Wooley v. Jackson Hewitt Inc.* was pending).

⁷⁹ See, e.g., VENKATESH, *supra* note 59, at 17, 32, 34, 106 (discussing off-the-books tax preparation).

⁸⁰ Cf. Sheppard, *supra* note 70 (stating that some wealthy taxpayers purchase tax insurance for family limited partnerships, an estate planning technique that arguably lacks economic substance).

government to compensate these individuals for their audit costs.⁸¹

There is another twist here, however: the amount of that compensation might well be zero, because the government already has a program in place that prevents low-income individuals from having to bear audit costs. Low Income Taxpayer Clinics provide free or low-cost audit representation to taxpayers who meet certain income and other need-based criteria.⁸² These clinics are partially funded by the IRS⁸³ but are completely independent of the government,⁸⁴ which helps prevent problems that might arise from the government's directly insuring against harms it causes. There is currently at least one federally funded Low Income Taxpayer Clinic in each of the fifty states, Washington, D.C., Guam, and Puerto Rico.⁸⁵ As one law school's website describes its clinic,

The clinic provides legal assistance to unrepresented, low income individuals who are being audited by the Internal Revenue Service [A]nyone who files a tax return is subject to audit[,] and . . . thousands of low income returns are audited each year. Tax clinic clients include cab drivers, travel agents, construction workers, retirees, flight attendants, nurses, high school teachers, car salesmen, waiters, immigrants, household workers, and many, many taxpayers with marginal businesses and terrible records.⁸⁶

Legal aid societies also sponsor such clinics. For example, the Low-Income Taxpayer Clinic (LITC) of the Legal Aid Society of New York assists taxpayers in disputes with the IRS and with the New York State Department of Taxation and Finance. Typical cases involve tax issues such as “[e]arned income tax credit (EITC); [c]hild tax credit; [f]iling status; [e]xemptions for dependents; [i]nnocent spouse relief; and [e]mployee classification.”⁸⁷ The free audit representation these clinics provide thus takes the place of audit insurance for low-income taxpayers.

⁸¹ Cf. Neil H. Buchanan, *The Case Against Income Averaging*, 25 VA. TAX REV. 1151, 1199–1202 (2006) (arguing that fairness may require income averaging for low-income earners, but not for the wealthy, because “[r]ough justice is always roughest on the poor”).

⁸² The IRS provides funding to a clinic only if 90% of the clinic's clients make less than 250% of the poverty guidelines (e.g., \$26,000 for an individual in 2008). IRS, LOW INCOME TAXPAYER CLINIC LIST (IRS PUB. 4143) (2008) [hereinafter LOW INCOME TAXPAYER CLINIC LIST], available at <http://www.irs.gov/pub/irs-pdf/p4134.pdf>.

⁸³ The IRS is authorized to provide a clinic up to \$100,000 in a matching-fund grant. I.R.C. § 7526(c)(2), (5) (2002).

⁸⁴ LOW INCOME TAXPAYER CLINIC LIST, *supra* note 82.

⁸⁵ *Id.* Larger states have more than one clinic. California and New York, for example, each have ten low-income taxpayer clinics that represent clients in controversies; Florida has eight, and Texas has six. *Id.*

⁸⁶ American University, Washington College of Law, Janet R. Spragens Federal Tax Clinic, <http://www.wcl.american.edu/clinical/federal.cfm> (last visited June 28, 2008).

⁸⁷ Legal Aid Society of New York, Low-Income Taxpayer Clinic, <http://www.legal-aid.org/en/whatwedo/civilpractice/low-incometaxpayerclinic.aspx> (last visited June 28, 2008).

Clinics may not resolve the compensation question in every case. Some taxpayers who are eligible to receive services from taxpayer clinics may not live close enough to a clinic to take advantage of those services.⁸⁸ Other taxpayers might make too much money to receive services from the clinic, but might still not be able to afford effective audit insurance. Fairness would require compensation for such taxpayers.

Thus, an egalitarian analysis suggests that because the market provides affordable and effective audit cost insurance to most taxpayers who want such insurance, it is generally fair for the government not to compensate taxpayers for the costs imposed by random audits. Nevertheless, fairness may require the government to compensate certain taxpayers, in particular low-income taxpayers for whom the market has failed.

* * * *

It is possible, however, notwithstanding philosophical arguments to the contrary, that people generally believe it is unfair for the government not to compensate taxpayers whom it selects randomly for audit. Part IV explains how a welfarist analysis of the compensation question suggests that this perceived unfairness should be a cause for concern and may in fact merit compensation.⁸⁹ Part V uses this welfarist framework to compare random audits with other situations, including checkpoint searches, jury service, and military services, in which the government imposes or has imposed costs randomly on subsets of individuals and either does not compensate the randomly selected individuals for the costs imposed or compensates them incompletely.⁹⁰

IV. WELFARISM AND PERCEIVED FAIRNESS

Welfarism, unlike egalitarianism, is concerned with fairness only if that fairness somehow contributes to social well-being. Empirical work suggests that a welfarist should be concerned with perceived fairness in the context of tax compliance because people have a “taste for fairness” in tax law, and are more likely to comply with laws that they perceive as fair. This Part first reviews welfarism in general, then shows how a welfarist analysis can be applied to tax compliance to highlight individuals’ taste for fairness in the context of law in general, and tax law in particular, and finally suggests one particular type of cost that unfairness related to noncompensation may impose.

⁸⁸ Some taxpayers might live close enough to a clinic to seek services but might not know that the clinic exists. Presumably, this situation could be resolved by educating taxpayers about the clinics and would not require compensation.

⁸⁹ See *infra* Part IV.

⁹⁰ See *infra* Part V.

A. *Welfarism*

Welfarism evaluates social choices based on how these choices affect overall well-being.⁹¹ In a purely welfarist world, decisionmakers would select a policy if that policy resulted in higher social welfare. Social welfare is, in turn, determined by reference only to individuals' well-being, or welfare. There are many ways to aggregate individual welfare—many social welfare functions—and different social welfare functions may provide different results. Thus utilitarianism, which determines social welfare by simply adding together each individual's welfare, is only one of many possible social welfare functions. Another possible welfarist approach might be to weigh the welfare of some individuals (e.g., poor people) more than the welfare of other individuals (e.g., rich people) before summing across individuals. This approach would sometimes result in different policies than would simple utilitarianism.

Just as there is no single social welfare function implied by welfarism, there is also no consensus on how an individual's welfare should be determined or quantified. An individual might be considered to have higher welfare if his preferences are satisfied, if his happiness is increased, or if he has more items on an "objective list" of "welfare goods" that might include friendship, health care, and so forth.

From a pure welfarist perspective, fairness, where fairness is a deontological principle concerned with something other than social well-being, is not an independent evaluative principle and therefore is not necessarily relevant to any given analysis. However, if social well-being depends in some way on fairness—if, for example, individuals have a "taste for fairness"—then a welfarist should factor fairness into his analysis.⁹²

As Part IV shows, empirical work suggests that individuals do in fact have a taste for fairness in law. In particular, empirical work suggests that people tend to comply more with laws that they perceive as fair.⁹³ In other

⁹¹ For a good summary of welfarism, on which the following description relies, see Matthew D. Adler & Chris William Sanchirico, *Inequality and Uncertainty: Theory and Legal Applications*, 155 U. PA. L. REV. 279, 291–96 (2006), and ADLER & POSNER, *supra* note 45, at 23.

⁹² See, e.g., TOM TYLER, WHY PEOPLE OBEY THE LAW 166 (2d. ed. 2006) (suggesting that issues of fairness may be incorporated into an expanded model of expected utility); Louis Kaplow & Steven Shavell, *Notions of Fairness Versus the Pareto Principle: On the Role of Logical Consistency*, 110 YALE L.J. 237, 249 (2000) ("[N]otions of fairness may be relevant under welfare economics, even though they are not considered to be independent evaluative principles. First, individuals may have tastes for notions of fairness, which is to say that their well-being may depend on whether what they view to be fair treatment is in fact provided Second, notions of fairness may serve as proxy principles that may be useful in identifying policies that advance welfare Third, notions of fairness can be important as rules of common morality, which are valuable to teach and reinforce because they lead individuals to be less opportunistic in their interactions in their everyday lives.").

⁹³ A welfarist might initially reject as irrelevant the fairness questions raised by random audit costs, arguing that individuals should be compensated for audit costs simply because of the declining marginal utility of money—in other words, even though fairness does not matter, equality still requires

words, in welfarist terms, these empirical results suggest that people derive utility from complying with laws they perceive to be fair.

B. *A Taste for Fairness in the Tax Law*

Many people have a preference for fairness.⁹⁴ Of particular interest for this Article, empirical work suggests that one factor that affects whether taxpayers comply with the law is whether taxpayers perceive the law as fair, procedurally, distributively, or, perhaps, retributively.⁹⁵ This Subpart discusses each type of perceived fairness in turn.

1. *Procedural Fairness*

Empirical studies show that people tend to obey laws in general, and tax law in particular, if they believe the authorities are legitimate, and people tend to believe authorities are legitimate if they believe that authorities implement the law in a procedurally just fashion.⁹⁶ In his classic study of Chicago residents' views of and experiences with law enforcement and the justice system, Tom Tyler found that individuals were

compensation. The idea here is that the more money one has, the less utility attaches to the next dollar. Imagine a society of ten people, in which everyone has \$100, and imagine that one person is randomly selected to bear audit costs of \$10. The welfarist might argue that everyone should be taxed in order to compensate this individual for his costs, because, given the declining marginal utility of money, it's better for everyone to have \$99 (because everyone pays \$1 of tax, and then that \$10 is given to the person who is audited) than for nine people to have \$100 and one person to have \$90. Fairness, on this view, is irrelevant, but equality is relevant. *Cf.*, e.g., Adler & Sanchirico, *supra* note 91, at 296–304 (discussing “equity-regarding” welfarism).

The assumption that money has a declining marginal utility may be incorrect. *See*, e.g., Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 472–79 (1952) (explaining some “formidable objections” to the conclusion that money has a declining marginal utility). But even if this assumption is correct, the equality argument is not a satisfactory answer to the fairness question, for at least two reasons in addition to the fact that, as discussed in the text, people do in fact have a taste for fairness in the tax context. First, this argument simply refuses the fairness question. The claim to be addressed is that people should be compensated for randomly imposed audit costs because it is unfair not to compensate them. Pure welfarism is a consequentialist approach that is concerned only with social well-being, and so it might (or might not) require an equitable distribution of goods, or equality of welfare; thus welfarism might require the government to compensate certain taxpayers for audit costs if such compensation would distribute income more equitably. But requiring an equitable distribution of welfare is not the same as requiring fairness. In other words, the welfarist's equality argument might seem close to a fairness argument, but it is still not a discussion of fairness; it is a discussion of welfare. And, second, those who are selected for audit do not have an equal amount of wealth prior to the imposition of audit costs. Compensation could be reworked so that money was moved around only within roughly equal slices of the population, but this begins to change the discussion entirely.

⁹⁴ *See*, e.g., Michael B. Dorff & Kimberly Kessler Ferzan, *Miscalculating Welfare* 15–18 (Southwestern L. Sch. Working Paper No. 0713, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102819 (discussing various empirical evidence of a preference for fairness).

⁹⁵ *See*, e.g., Donald Braman, *Punishment and Accountability: Understanding and Reforming Criminal Sanctions in America*, 53 UCLA L. REV. 1143, 1165 (2006) (“The importance of perceptions of fairness to cooperation, long assumed by prominent legal theorists, has been thoroughly established across a broad array of recent empirical studies . . .”) (citations omitted).

⁹⁶ *See*, e.g., TYLER, *supra* note 92, 3–6.

more likely to comply with laws that they believed to be just.⁹⁷

In particular, if individuals believed that laws were implemented justly—if they perceived that the authorities were procedurally just—they tended to believe that the authorities were legitimate, which in turn led to compliance. This is to be distinguished from an outcome-oriented approach; that is, even people who did not get the legal outcome they desired sometimes felt that the law was implemented in a procedurally just fashion and that the result was just, and this in turn sometimes caused them to comply with the law.⁹⁸ Individuals tended to believe the laws were enforced justly if they believed that the authorities were impartial—that is, the authorities were trying to be fair, honest, and unbiased. Individuals also felt it was important that the authorities demonstrated a concern for individuals' rights.

Tyler's work did not study individuals' views of and experiences with tax authorities in particular, but consistent with Tyler's work, studies have shown that taxpayers who believe the IRS is fair are more likely to comply with tax reporting and payment requirements.⁹⁹ These studies demonstrate that taxpayers tend to comply with tax laws if they believe that the procedures the tax authority uses to determine tax liability and enforce tax laws are fair—that is, taxpayers respond to perceived procedural justice.¹⁰⁰ For example, tax compliance might be improved if individuals feel they are treated "equitably and consistently"¹⁰¹ and that tax authorities "tr[y] to be fair when making their decisions."¹⁰² Interestingly, although consistency would seem to be an important element of procedural justice, studies have shown that consistency over time or as between individuals does not seem to have a strong effect on whether people believed that authorities were procedurally just,¹⁰³ suggesting that randomness may be consistent with

⁹⁷ *Id.* at 8–15.

⁹⁸ *Id.* at 269–70 (contrasting instrumental theories of compliance with normative theories of compliance).

⁹⁹ See, e.g., Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, in *WHY PEOPLE PAY TAXES* 223 (Joel Slemrod ed., 1992) (arguing that procedural fairness increases compliance and defining procedural fairness as whether taxpayers can tell "their side of the issue," whether the IRS tries to be fair, whether the IRS's decisions are correctable, and whether individuals are treated "equitably and consistently"); Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599, 614–17 (2007); Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. KAN. L. REV. 971, 991, 996–1004 (2003) (discussing various studies that show that perceived procedural fairness increases compliance with laws in general and tax laws in particular).

¹⁰⁰ Michael Wenzel, *The Impact of Outcome Orientation and Justice Concerns on Tax Compliance: The Role of Taxpayers' Identity*, 87 J. APPLIED PSYCHOL. 629, 631 (2002). Certain kinds of noncompliance, such as underreporting income and overreporting deductions, are particularly likely to be affected by a taxpayer's belief that a taxing authority is fair. *Id.*

¹⁰¹ Smith, *supra* note 99, at 224.

¹⁰² Wenzel, *supra* note 100, app. at 644–45. Other factors might include whether taxpayers have input in formulating tax laws, whether taxpayers have the chance to tell their side of the story, and how correctable decisions are. *Id.* at 631; Smith, *supra* note 99, at 224–25.

¹⁰³ TYLER, *supra* note 92, at 153–54.

perceived procedural justice.

2. *Distributive Fairness*

People also tend to obey laws if they believe that the outcome of the laws is distributively just.¹⁰⁴ Although Tyler does not focus on distributive justice, he notes that whereas assessments of procedural justice tend to influence views and beliefs, studies show that assessments of distributive justice tend to influence behavior. Thus, assessments of distributive justice might lead to compliance (or noncompliance) directly, without being mediated by an increased belief in legitimacy.¹⁰⁵

The burden of audit costs might be perceived as, and in some sense is, an additional tax. Some taxpayers bear this additional burden, and some do not. If taxpayers are concerned about horizontal equity, in particular whether similarly situated taxpayers are treated similarly *ex post*, they may object to being asked to bear a greater burden than other taxpayers who, for example, have the same income level.¹⁰⁶ Some studies show that perceptions of horizontal equity affect compliance; others show they do not.¹⁰⁷ Furthermore, we do not know whether taxpayers view the burden of audit costs as raising questions of horizontal equity, or, if they are concerned about horizontal equity, whether they prefer *ex post* horizontal equity to *ex ante* horizontal equity.

Similarly, the opportunity to avoid tax may also be seen as a resource that is distributed fairly (or unfairly) among taxpayers. For example, some taxpayers may feel that wealthy individuals have more of a chance to avoid taxes—that the resource of “avoiding tax” is distributed disproportionately and unfairly to wealthy taxpayers.¹⁰⁸ In that case, random audits might be perceived as distributively fair because wealthy taxpayers would no longer have more of a chance than other taxpayers to evade audit costs or audits and thus to evade having to pay the correct amount of tax. Instead, everyone would have the same *ex ante* opportunity to avoid the costs of audit. In contrast, statistical profiling (for example, using DIF scores to

¹⁰⁴ See, e.g., *id.* at 103–04 (discussing society’s tendency to obey laws perceived as distributively fair).

¹⁰⁵ See, e.g., *id.* (citing Sheldon Alexander & Marian Ruderman, *The Role of Procedural and Distributive Justice in Organizational Behavior*, 1 SOC. JUST. RES. 177 (1987)).

¹⁰⁶ Some policymakers and courts continue to use the concept of horizontal equity to evaluate tax provisions. See, e.g., *Dilts v. United States*, 845 F. Supp. 1505, 1510 (D. Wy. 1994) (“One fundamental purpose of the tax code is to achieve ‘horizontal equity’—that is, to treat similarly situated people in the same manner.”); *Kenseth v. Comm’r*, 114 T.C. 399, 425 n.15 (2000) (referring to results in certain cases as “unsatisfactory . . . from a horizontal equity standpoint”); CONG. RES. SERV., ADDITIONAL STANDARD TAX DEDUCTION FOR THE BLIND 3 (July 12, 2006) (“It may . . . be said that the additional standard deduction accorded the blind does not meet horizontal equity principles.”).

¹⁰⁷ See, e.g., Michael Wenzel, *Tax Compliance and the Psychology of Justice: Mapping the Field*, in TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION 41, 49–50 (Valerie Braithwaite ed., 2002) (reviewing studies).

¹⁰⁸ *Id.*

select taxpayers for audit) might be seen as distributively unfair, because individuals with characteristics that suggest they might try to evade taxes would have less of a chance to avoid the costs of audit. This might seem especially unfair if those characteristics were themselves morally neutral—for example, if people who took home office deductions tended to be audited, and thus to receive a too-small share of the resource of “avoiding audit.” On the other hand, these two factors might interact; if statistical profiling tended to result in audits of wealthy individuals, taxpayers might feel statistical profiling was more distributively fair than random audits, because it would balance the perception that wealthy individuals are more likely able to evade taxes.

3. *Retributive Fairness*

Finally, retributive justice may also be a factor in why people obey the laws.¹⁰⁹ If an audited taxpayer believes that an audit and the costs it imposes are retributive, and the taxpayer believes he is innocent, he may feel he is being treated unfairly, and this may negatively affect his future compliance with the tax law. This is the feeling that Senator Paul Coverdell appeared to be playing on when he introduced legislation that would have banned random audits.¹¹⁰ He claimed that the IRS had “identified a new enemy: innocent taxpayers,” who had

committed no wrong, [but were simply] unfortunate victims of an IRS practice called “random audits,” where the IRS simply picks people out of a hat in the hope it can uncover some wrongdoing. . . . Americans will not accept the IRS’s assertion that enforcement requires them to go after innocent, low-income taxpayers by using random audits that make no distinction between the guilty and innocent Congress is deadly serious about the need to end random audits.¹¹¹

Putting aside whether the audits Senator Coverdell was attacking truly were random,¹¹² he may have been making a retributive justice point: if audits themselves seem punitive,¹¹³ and punishing innocent individuals at

¹⁰⁹ *Id.* at 58–60 (“[R]esearchers have argued that taxpayers subject to investigation . . . could resent their treatment, find . . . audits unreasonably intrusive, and as a consequence develop more negative attitudes towards the [taxing authority].”).

¹¹⁰ 144 CONG. REC. S3791 (daily ed. Apr. 29, 1998) (introducing the Internal Revenue Service Random Audit Prohibition Act).

¹¹¹ *Id.*

¹¹² Technically, the taxpayers to which Senator Coverdell referred were audited as part of certain IRS projects. IRS’ USE OF RANDOM SELECTION, *supra* note 12, at 1–4. For a discussion of IRS projects, see *supra* text accompanying notes 10–14. It also seems unlikely that Congress was “deadly serious” about ending random audits, given that the bill was referred to the Committee on Finance and then never heard from again. For a further discussion of Senator Coverdell’s concerns, see *infra*, text accompanying notes 191–94.

¹¹³ Random audits are, of course, not intended to be punitive.

random is unfair, then random audits may seem unfair.

Therefore, even a pure welfarist analysis should take into account whether random audit costs are fair, or at least whether they seem fair. The next Subpart describes more fully the form that a welfarist analysis of individual tax compliance might take.

C. *Welfarism and Optimal Taxation*

A welfarist analysis of taxation often takes the form of an optimal taxation model, that is, a model which maximizes social welfare subject to certain constraints,¹¹⁴ which may represent, among other things, the amount of revenue the government needs and how taxpayers respond to taxes.¹¹⁵ As discussed above, social welfare is defined as some type of aggregation of individual welfare.¹¹⁶ This Subpart focuses on the traditional definition of individual welfare in an optimal taxation model to show that the traditional definition falls far short of explaining actual compliance with tax law, highlighting how a preference for fairness is one relevant factor that is excluded from that model.

Note that this Subpart presents a mathematical model of the conceptual point above—that financial incentives do not fully explain tax compliance in the United States—and may therefore be omitted by readers who prefer to avoid formulas.

1. *The Traditional Model*

An optimal taxation model often includes the simplifying assumption that an individual's welfare is fully determined by consumption and the action taken to produce that income. That is, where W is total welfare, C is consumption, and a is the action taken that results in the income (specifically, it results in probability levels over a set of possible income values), it is often assumed that $W = U(C) + G(a)$.¹¹⁷ Additionally, because people are assumed to attempt to maximize their own utility, individuals under a welfarist analysis will pay their taxes if the utility of paying taxes is greater than the utility of not paying taxes. That is, where

$$I = \text{realized income}$$

¹¹⁴ The seminal article on this topic is James Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971).

¹¹⁵ See, e.g., William M. Gentry, *Optimal Taxation*, in THE ENCYCLOPEDIA OF TAXATION & TAX POLICY 307, 307 (Joseph J. Cordes, Robert D. Ebel, & Jane G. Gravelle eds., 1999).

¹¹⁶ See *supra* Part IV.A.

¹¹⁷ See, e.g., Mirrlees, *supra* note 114, at 176 (defining utility as a function of consumption and time worked); Dilip Mookherjee & Ivan Png, *Optimal Auditing, Insurance, and Redistribution*, 104 Q. J. ECON. 399, 402 (1989) (defining welfare over consumption and action); David A. Weisbach, *What Does Happiness Research Tell Us About Taxation?* 5 (Univ. of Chi. John M. Olin L. & Econ. Working Paper No. 342 (2d Ser.), 2007), available at http://ssrn.com/abstract_id=995319 ("A simplifying assumption often used [in optimal taxation] . . . is that utility is quasi-linear in consumption, so that utility can be expressed as $u = c + v(l)$ where c is consumption and l is labor effort.").

$U(*)$ = utility of consumption

T = tax due on realized income

t = tax due on reported income

F = penalty for inaccurate reporting (if audited); $F \geq 0$

p = probability of audit

a taxpayer should report accurately where

$$U(I - T) > pU(I - T - F) + (1 - p)U(I - t).$$

Fairness is irrelevant here. Of course, this equation oversimplifies compliance. For example, even if the IRS audits a taxpayer, it is not certain that the IRS will determine his actual taxable income. More interesting for our purposes, this equation highlights one way the definition of welfare provided above is too simple. The equation assumes that people weigh the utility of complying with tax law against the utility of not complying. Utility for these purposes is a function only of income, and the relative outcomes of compliance and noncompliance are weighted by the probability of audit. But, as many have noted, if this were truly how people determined the utility of complying with tax law, nobody would comply because audit rates are so low.¹¹⁸

The explicit audit rate for individuals is less than one percent.¹¹⁹ Even if a taxpayer could expect to pay, in addition to the tax he should have paid had he reported correctly, a penalty equal to one hundred percent of that tax,¹²⁰ or if a taxpayer makes the decision whether to report purely by weighing the expected financial outcomes, it would be irrational for any

¹¹⁸ See, e.g., Kornhauser, *supra* note 99, at 601 (“Traditional methods of enforcement through audit and penalties explain only a small fraction of voluntary tax compliance.”); Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation* 5 (Ctr. for Tax Sys. Integrity, Austl. Nat’l Univ. 2005), available at <http://ctsi.anu.edu.au/publications/WP/76.pdf> (“Several scholars have established that selfish individuals would be rational not to pay taxes, because the probability of being detected and the size of fines in many countries are so low that it is advantageous to evade. Tax payment is . . . taken to be a ‘quasi-voluntary’ act.”); Joel Slemrod, *On Voluntary Compliance, Voluntary Taxes, and Social Capital*, 51 NAT’L TAX J. 485, 485 (1998) (“Given the probability of audit and the penalties typically assessed, evasion seems to be a winning proposition . . . the puzzle is not to explain why people evade, but rather why people pay taxes—in the context of the standard economic model, people who voluntarily comply are exhibiting nothing short of ‘pathological honesty.’”); see also Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (2000) (“A widespread view among tax scholars holds that law enforcement does not explain why people pay taxes.”).

¹¹⁹ Over the last eight years it has been as low as .49% (in 2000) and as high as .98% (the estimated rate for 2006). IRS, Fiscal Year 2006 Enforcement and Service Results, http://www.irs.gov/pub/newsroom/11-06_enforcement_stats.pdf (last visited Sept. 1, 2008); Table 9—Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, Fiscal Year 2007, <http://www.irs.gov/pub/irs-soi/07db09ex.xls> (last visited July 4, 2008) (stating that the total audit rate for individual returns in taxable year 2007 was .9%).

¹²⁰ Generally, the maximum penalty for misreporting taxable income is only seventy-five percent of the tax that would have been owed. This maximum penalty is imposed only if the IRS determines that the taxpayer has misreported fraudulently. I.R.C. § 6663(a) (2002).

given taxpayer to comply with tax reporting and payment requirements.¹²¹

However, the mismatch between expected compliance and actual compliance is somewhat less stark than the explicit audit rate implies because the explicit audit rate understates how much information the government receives about taxpayers. Information reporting and withholding taxes provide the government with information about the taxpayer, or with tax payments on the taxpayer's behalf, with little or no input from the taxpayer.¹²² The tax code requires certain payors to submit forms to the IRS stating how much was paid and to whom.¹²³ For example, employers must submit W-2 forms to the IRS, with a copy to the employee, and a bank paying interest must submit a Form 1099-INT to the IRS, with a copy to the depositor. It is relatively easy for the IRS to determine whether a taxpayer's reporting matches up with what has been reported by the payor. For example, the IRS has a matching program to confirm that information reporting for wages matches taxpayers' individual returns.¹²⁴ Employers are also required to withhold income taxes from employees' wages.¹²⁵ Compliance rates with respect to wage and salary income, which are subject to both information reporting and withholding,

¹²¹ Criminal sanctions may also play a deterrent role, but very few taxpayers are criminally investigated, and most of the subjects of criminal tax investigations obtain their money from illegal sources, such as narcotics, money laundering, or currency violations. In fiscal year 2007, for example, the IRS criminal investigation program initiated 4211 investigations; only 1664, or about 40%, of these investigations involved legal-source tax crimes. Also in 2007, the IRS criminal investigation program obtained 2155 convictions. Of those individuals, 732, or about 34%, had been prosecuted due to crimes related to legal-source income. Table 18—Criminal Investigation Program, by Status or Disposition, Fiscal Year 2007, <http://www.irs.gov/pub/irs-soi/07db18ci.xls> (last visited July 4, 2008). These investigations and convictions are related to returns filed in various fiscal years, and we do not, of course, know the actual number of tax criminals, but to give a sense of how tiny the number of criminal investigations is, the IRS received 138,894,000 individual income tax returns for the 2007 tax year. Table 2—Numbers of Returns Filed, by Type of Return, Fiscal Years 2006 and 2007, <http://www.irs.gov/pub/irs-soi/07db02nr.xls> (last visited July 4, 2008).

¹²² See generally Lederman, *supra* note 99 (discussing the audit-like qualities of information returns and withholding).

¹²³ See generally I.R.C. §§ 6041–6053 (requiring, inter alia, information returns for interest payments, I.R.C. § 6049, information returns for wages paid to employees, I.R.C. § 6051, and information returns for certain purchases of fish, I.R.C. § 6050R (defining “fish” as including other forms of aquatic life)).

¹²⁴ J. RUSSELL GEORGE, HEARING BEFORE THE U.S. SENATE COMMITTEE ON FINANCE, A CLOSER LOOK AT THE SIZE AND SOURCES OF THE TAX GAP 21 (2006), available at http://www.treas.gov/tigta/congress/congress_07262006.pdf.

¹²⁵ I.R.C. § 3402(a). This system does not make cheating impossible, of course. For example, it is possible for an employee to cheat by overstating the number of exemptions to which he is entitled, or by claiming to be exempt from employment tax withholding. Claiming “exempt” status on Form W-4 was, as recently as 2006, on the IRS's list of “the most notorious tax schemes” for the year. News Release, IRS, IRS Announces “Dirty Dozen” Tax Scams for 2006 (Feb. 7, 2006), available at <http://www.irs.gov/pub/irs-news/ir-06-025.pdf>. See, e.g., The Disciples of Truth, Sec. 3402. Income Tax Collected at Source, <http://www.tax-freedom.com/ta06009.htm> (last visited June 29, 2008) (“W-4s are supposed to relate to employment taxes, why are you specifying deductions for the income tax on your W-4? Are you a non-resident alien???? Did they tell you that you were voluntarily agreeing to have your earnings subjected to income tax withholding as well as employment tax withholding? You don't have to participate in, or remain victimized by, this fraud if you don't want to!”).

are 95% or greater. For example, in 2001, taxpayers whose income was subject to substantial information reporting and withholding reported 98.8% of their income accurately.¹²⁶

If we set aside the withholding and information reporting regime, though, accurate reporting of net income that is subject to little or no information reporting or withholding is still much higher than the explicit audit rate would predict: about 46% of such income was accurately reported in 2001.¹²⁷ This compliance rate is far higher than it would be if individuals were engaging in a purely financial cost-benefit analysis, comparing the amount of money they expected to retain by misreporting their income, on the one hand, with the amount of money they expected to retain by reporting honestly.¹²⁸ Of course, taxpayers may be wildly overestimating their chances of being audited,¹²⁹ or of being subject to criminal prosecution.¹³⁰ But even if that is the case, it seems likely that something further is needed to explain why taxpayers are complying more than a cost-benefit analysis would predict, where costs and benefits are a function of income only.

The next Subpart provides a formula that encapsulates the relevance of perceived fairness to welfarists.

2. *Expanding Utility*

Put another way, when a taxpayer is deciding whether to comply with tax law, his welfare function is apparently not defined simply over consumption and income-producing action. There may be some utility (or disutility) associated with the action of complying with the tax law itself.

¹²⁶ See U.S. GEN. ACCOUNTING OFFICE, *TAX COMPLIANCE: OPPORTUNITIES EXIST TO REDUCE THE TAX GAP USING A VARIETY OF APPROACHES* 10 (2006) (indicating that 1.2% of individuals subject to substantial information reporting and withholding misreported their income).

¹²⁷ See *id.* (indicating that 53.9% of individuals subject to little or no reporting misreported their income); see also Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1457–58 & n.22 (2003) (noting that the compliance rate for self-employment income is about 42% and citing sources to support the proposition that “it is often stated in the tax compliance literature that deterrence does not explain voluntary compliance levels in the United States”).

¹²⁸ *Id.* See generally Slemrod, *supra* note 118.

¹²⁹ See, e.g., JAMES ALM, BETTY R. JACKSON & MICHAEL MCKEE, *THE EFFECTS OF COMMUNICATION AMONG TAXPAYERS ON COMPLIANCE* 38 (2004), available at <http://www.irs.gov/pub/irs-soi/04alm.pdf> (noting that nobody knows the extent to which taxpayers understand the true audit rate, or how they form their beliefs about the audit rate, but hypothesizing, based on an experiment, that communication between taxpayers regarding the audit rate increases compliance more than communication from the IRS); Tom Herman, *Fear of the Home Office Deduction*, WALL ST. J., Jan. 16, 2008, at D3, available at LEXIS, News Library, WSJ File (stating that “many” people do not take home-office tax deductions in an attempt to avoid triggering an audit, but that these “fears of getting audited are exaggerated,” and “most people who claim the home-office deduction don’t get audited”); cf., e.g., Eric A. Posner, *Probability Errors: Some Positive and Normative Implications for Tort and Contract Law*, 11 S. CT. ECON. REV. 125, 125 (2004) (discussing empirical studies that show “people make systematic errors when they estimate probabilities”).

¹³⁰ See discussion *supra* note 121.

That is, instead of welfare equaling

$$U(C) + G(a)$$

where C is consumption and a is the action that produces the income, I suggest that we should add at least one other term to the welfare function, defining a function, $H(x,y)$, as representing the utility of reporting income that would result in tax equaling x where reporting actual income would result in tax equaling y .¹³¹ Thus the welfare function would equal

$$U(C) + G(a) + H(x,y)$$

In other words, given current audit levels, a taxpayer who is attempting to maximize his welfare and who complies with tax law must derive utility from something more than consumption and income-producing action.¹³² Starting with the compliance equation discussed above,¹³³ but taking into account H , if

I = realized income

$U(*)$ = utility of consumption

T = tax due on realized income

t = tax due on reported income

F = penalty for inaccurate reporting (if audited); $F \geq 0$

p = probability of audit

$H(x,y)$ = utility of reporting income resulting in tax x
where tax due on realized income is y

then a taxpayer should report accurately where

$$U(I - T) + H(T, T) > pU(I - T - F) + (1 - p)U(I - t) + H(t, T).$$

Notice that H is not weighted by the probability of audit. This is to indicate that the taxpayer will derive the utility of reporting honestly (or

¹³¹ I assume (to simplify the notation) that the amount of tax due on income is a one-to-one function. That is, there is only one value of reported income that will result in any given tax amount. In other words, for any given income i and tax x , if reporting income i results in tax due of x , then if the tax due is x , the taxpayer must have reported income i . Thus if the taxpayer owes tax T , the taxpayer must have reported income I , his realized income—that is, the taxpayer must have reported honestly.

¹³² See generally Robert Cooter, *The Intrinsic Value of Obeying a Law: Economic Analysis of the Internal Viewpoint*, 75 FORDHAM L. REV. 1275 (2006). Cooter makes essentially the same point, although in different terms. He suggests that some people may be willing to pay to obey a law; that is, instead of weighing the cost of obeying against the cost of disobeying, an individual who has “internalized” obedience will obey if his willingness to pay to obey a law exceeds the cost of obeying less the cost of disobeying. Thus, in Cooter’s account, an individual obeys if willingness-to-pay exceeds the cost of obeying less the cost of disobeying. *Id.* at 1281–82.

¹³³ See *supra* Part IV.C.1.

not reporting honestly) regardless of whether he is audited.¹³⁴

There are likely many factors that determine $H(T, T)$. For example, holding all else equal, people may pay their taxes because they want to obey social norms favoring tax compliance, so strengthening these norms may increase $H(T, T)$ (or decrease $H(t, T)$), and thus increase compliance.¹³⁵ And, crucially for our purposes, one element of a taxpayer's welfare function may relate to whether tax law is fair.¹³⁶ As the previous Part discusses, empirical work has shown that individuals tend to comply with the law if they believe the law and legal authorities are procedurally and distributively fair, and perhaps retributively fair as well.¹³⁷

Therefore, examining whether randomly imposing audit costs seems unfair illuminates whether compensating taxpayers for these costs is desirable even if one is completely committed to a welfarist approach to taxation. Put another way, a rule about imposing audit costs that appears fair may increase $H(T, T)$, and thus may increase taxpayer compliance and, in turn, overall welfare.¹³⁸

D. *The Cost of Perceived Unfairness*

Taking account of perceived fairness in a welfarist context may seem to require an almost impossible precision. In order to determine whether perceived fairness mandates compensation for randomly imposed audit costs, we would have to monetize all costs and benefits associated with random audits, including emotional costs and opportunity costs, and

¹³⁴ As discussed *infra* Part IV.C.2. H may be defined in part by the probability of audit, but not necessarily by the probability that the individual will be audited; rather, it may be determined by the total probability of audit, over all possible incomes—that is, the entire probability function.

¹³⁵ See, e.g., Posner, *supra* note 118, at 1782. As Posner notes, underenforcement may go hand-in-hand with strong social norms in favor of compliance. *Id.*

¹³⁶ See, e.g., Dorff & Ferzan, *supra* note 94, at 18 (“Because individuals weight fairness so heavily, any policy that seeks to enhance their welfare must take account of their fairness preferences.”).

¹³⁷ Some might argue that individuals prefer to comply with law that is actually fair, not with law that they simply believe to be fair. Cf., e.g., ADLER & POSNER, *supra* note 45, at 31 (“Ordinary citizens really do have some preferences for things other than their own experiences. An individual may prefer not to be exposed to a toxin. This is not the same as a preference not to perceive a risk from the toxin.”). However, there is no objective definition of what it means for something to be fair. If a law is not fair in the view of a taxpayer, the taxpayer does not get utility from complying with that law simply because the law is fair in the view of a famous philosopher. Thus, if we assume that the government is not lying about its approach to auditing, a law is fair for these purposes precisely when the taxpayer believes it to be fair. Of course, a philosophical argument about fairness, such as the argument presented *supra* Part III.A., may be relevant to the extent that it is persuasive to a large group of taxpayers. For these purposes, however, it is not determinative.

¹³⁸ The claim here is not that the fairness of random audits fully determines $H(T, T)$. Indeed, it seems highly likely that even the fairness of the tax system as a whole does not fully determine $H(T, T)$. What is more, while adding a term representing the utility of complying with the law may make the utility function more descriptive of the real world, there may be some other factor altogether, unrelated to the utility of complying with the law, that will make the overall welfare function even more accurate. Thus, the claim is simply that adding $H(T, T)$ may increase the accuracy of modeling the taxpayer's welfare function, and that, in turn, the fairness of random audits may have some effect on $H(T, T)$.

determine whether monetized fairness-related costs tipped the balance toward compensation.¹³⁹ But this impossible precision is not unique to the question of whether to compensate individuals for audit costs. Indeed, most who make decisions by weighing costs and benefits either omit costs that are not already monetized or engage in some sort of estimation or “casual empiricism.”¹⁴⁰

To incorporate fairness into a welfarist model, we must begin by speculating on the relative costs of different kinds of perceived unfairness. Different kinds of perceived unfairness likely impose different kinds of costs. In particular, there may be factors that increase the costs of unfairness in the context of failure to compensate taxpayers for randomly imposed burdens. Frank Michelman’s work on demoralization costs provides useful guidelines for thinking about the magnitude of the costs of such unfairness. This Subpart describes Michelman’s work in the context of takings, and then expands his definition of demoralization costs to take into account randomly imposed burdens.

In Michelman’s scheme, demoralization costs arise directly from noncompensation for government-imposed burdens and are a combination of the nonfinancial “disutility” an individual suffers when the government takes something of value that belongs to him and provides him with no compensation¹⁴¹ and the loss of production that results from the lack of compensation, caused by “demoralization of uncompensated losers, their sympathizers, and other observers disturbed by the thought that they themselves may be subjected to similar treatment on some other occasion.”¹⁴² Michelman suggests that demoralization costs (i.e., the costs of uncompensated government-imposed burdens) may be particularly high when first, very few people bear the burden for which compensation is

¹³⁹ Questions to be studied might include how taxpayers currently view random audits; how being compensated for costs imposed by random audits would affect taxpayers’ views of these audits; and how education about random audits might affect taxpayers’ perceptions of these issues.

¹⁴⁰ See, e.g., Cass R. Sunstein, *Cost-Benefit Analysis Without Analyzing Costs or Benefits: Reasonable Accommodation, Balancing, and Stigmatic Harms*, 74 U. CHI. L. REV. 1895, 1903–04 (2007) (using the term “casual empiricism” to describe Judge Posner’s decision-making in a particular case that involved weighing costs and benefits and stating that “[a] standard difficulty with cost-benefit analysis is that it may neglect costs and benefits that are not easily measured”); see also Matthew D. Adler, *Fear Assessment: Cost-Benefit Analysis and the Pricing of Fear and Anxiety*, 79 CHI.-KENT L. REV. 977, 977 (2004) (“[Agencies] almost never enumerate and price the distressing mental states . . . that are causally connected to environmental, occupational, and consumer hazards.”). It may be possible to quantify emotions such as fear and incorporate these quantifications into cost-benefit analysis, but such quantification is rarely carried out. *Id.*

¹⁴¹ Michelman defines it as “the dollar value necessary to offset disutilities which accrue to losers and their sympathizers specifically from the realization that no compensation is offered.” Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of “Just Compensation”* Law, 80 HARV. L. REV. 1165, 1214 (1967).

¹⁴² *Id.* Michelman limits this to “the present capitalized dollar value of lost future production (reflecting either impaired incentives or social unrest) caused by demoralization of uncompensated losers, their sympathizers, and other observers.” *Id.*

sought; second, the costs of compensation, including both the amount of compensation and the costs of administering the compensation, are low; third, the costs imposed do not appear to be required by efficiency; and, fourth, when different individuals bear the cost than reap the benefits.¹⁴³

Michelman argues that demoralization costs arise in the context of takings because people do not want to be subject to “majoritarian exploitation”—that is, they do not want to be “at the mercy of majorities.”¹⁴⁴ Once strategy comes into play, an individual might be systematically exploited. There is no comparable urgency for at least two reasons, he argues, when it comes to compensating an individual for random burdens. First, an individual may seek insurance against randomly imposed burdens, but more importantly, there is no attendant loss of morale when it comes to random burdens. Second, an individual is not “uneasy” about such burdens because he simply has no control over them. In contrast, individuals who are purposely selected by the government because of specific characteristics bear heavy demoralization costs.

Burdens imposed by the government on random individuals are in some sense purposive¹⁴⁵—that is, the government, presumably enacting the will of the majority, has made the specific decision to impose costs. But the identity of the individuals who will bear these costs is not purposive. The possibility of a given individual’s loss is not determined by strategy—indeed, randomness is valuable precisely because of this lack of strategy. Nonetheless, *pace* Michelman, it seems likely that demoralization costs attend randomly imposed burdens, in the sense that being selected randomly to bear a burden and not receiving any compensation may itself impose a cost on an individual and may cause his sympathizers, or those who hear of his situation, to act in ways that reduce social welfare overall. For example, as discussed above, in the absence of random audit compensation, people may be less likely to comply with the tax law if they feel strongly that it is unfair to audit people at random and not compensate them for the costs they incur.

At least five factors may create or increase demoralization costs in the context of random burdens. Four of the factors are the same as those related to Michelman’s demoralization costs as he defined them in the context of takings: demoralization costs related to random burdens may be higher (1) if very few people bear the burden for which compensation is sought; (2) when the costs of compensation are low; (3) when the costs imposed appear unnecessary; and (4) when the benefits of the burdens accrue to people other than those who bear the burdens.¹⁴⁶ Additionally,

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 1165, 1216–17.

¹⁴⁵ *Id.* at 1217.

¹⁴⁶ *Id.* at 1214.

demoralization costs related to random burdens may be higher if the underlying government function is unpopular.¹⁴⁷ For example, an individual may be unconcerned if he is not compensated for costs he bears as a result of being randomly selected at an airport search intended to prevent terrorism, as he may feel that preventing terrorism is generally a function he wants the government to perform.

The concept of demoralization costs in the context of random burdens, and the five factors that may increase such demoralization costs, can help provide a general sense of how much the unfairness of random, uncompensated audit costs decreases overall utility. The next Part uses these five factors to incorporate unfairness into a rough model of costs and benefits related to government compensation for various randomly imposed burdens, including random audits.

V. WHEN DOES COMPENSATION MAKE SENSE IN THE REAL WORLD?

Actual fairness does not require compensation for most randomly-imposed audit costs. However, a welfarist analysis suggests that perceived fairness should be incorporated into the mix of costs and benefits that accrue when an individual is randomly selected by the government to bear costs for the good of society as a whole. In particular, whether the tax law is perceived as fair should matter to someone committed to an efficiency analysis of tax compliance, for empirical work shows that individuals prefer to comply with laws that they perceive as fair.

Although, as discussed above, firm empirical evidence about the costs of random audits, financial, emotional, and otherwise, would be ideal when creating a welfarist model to determine whether perceived fairness requires compensation for random audits, this type of information is, and may remain, unavailable.¹⁴⁸ In the meantime, proposals for audit compensation continue. So, notwithstanding the absence of precise monetization of costs and benefits, this Part suggests an answer to the compensation question by comparing the burden of random audit costs with three other kinds of government-imposed random burdens: checkpoint searches, jury service, and military service. For each type of burden, this Part first explains why the burden is imposed randomly, then reviews the direct financial costs, opportunity costs, emotional costs, and demoralization costs that attend being randomly selected to bear the particular burden. It examines the benefits, if any, of being selected (including compensation), and finally discusses whether insurance is available for the randomly imposed costs. This Part concludes by arguing that some nominal amount of random audit

¹⁴⁷ Michelman's article does not reach this point because it addresses only one kind of government-imposed cost: takings under the Fifth Amendment. *Id.* at 1165.

¹⁴⁸ See *supra* Part IV.D.

compensation may be useful to mitigate concerns about perceived unfairness. Compensation might not be the only way to mitigate these concerns, however, because the costs associated with perceived unfairness may be greater because of the public's overall lack of understanding of random audits and negative view of the IRS. Thus, education about the goals of random audits and about the IRS might complement, or even replace, compensation as an effective way of reducing the fairness-related costs of uncompensated random audits.

A. Checkpoint Searches

1. Randomness

There are many ways to determine who will be the subject of a checkpoint search, but, in general, searches and seizures are deemed fairer if the individual examined was not selected because of a personal characteristic. For example, the Second Circuit has upheld random subway searches as constitutional under the Fourth Amendment in part because “police exercise no discretion in selecting whom to search, but rather employ a formula that ensures they do not arbitrarily exercise their authority.”¹⁴⁹ The court took care to state in the first sentence of the opinion that the searches were “random,” and noted in the facts section of the opinion that the police officers

exercise virtually no discretion in determining whom to search. The supervising sergeant establishes a selection rate, such as every fifth or tenth person, based upon considerations such as the number of officers and the passenger volume at that particular checkpoint. The officers then search individuals in accordance with the established rate only.¹⁵⁰

Similarly, the Fifth Circuit has upheld the constitutionality of stopping cars at a checkpoint near a military base in part because cars were stopped randomly:

That the checkpoint stopped every sixth vehicle, rather than every single vehicle, counters any suggestion of subjective intrusion because it might dispel any concern of a law-abiding motorist that she had been singled out. There is no evidence that [the defendant] was singled out or treated arbitrarily or that the officers were operating with unfettered

¹⁴⁹ *MacWade v. Kelly*, 460 F.3d 260, 263, 273 (2d Cir. 2006).

¹⁵⁰ *Id.* at 265. As discussed *supra* Part II.A, in the context of audits, randomness may have other, practical advantages as a law enforcement mechanism—for example, it may increase the deterrent effect of searches, *see, e.g., MacWade*, 460 F.3d at 274; *United States v. Marquez*, 410 F.3d 612, 618 (9th Cir. 2005) (upholding random searches of airline passengers)—but I am interested here only in whether it increases fairness.

discretion as to which cars to stop.¹⁵¹

The court suggests, at least in this limited situation, that randomness makes the imposition of these costs more acceptable and more fair. But it is also true that some individuals bear the costs of searches, and some do not.

2. *Costs*

Checkpoint searches impose essentially no direct financial costs. They impose a relatively small time cost—the subject of the search does have to give up fifteen or twenty minutes of his time, but the opportunity cost of such a brief period of time will generally be low. The emotional cost of searches likely varies widely, depending on the individual searched. For some, being stopped might be a mere nuisance; for others, having their car searched by a police officer may verge on the traumatic.

Finally, demoralization costs in this context are likely to be low. The only factor that might suggest higher demoralization costs is that the costs of compensation, including administrative costs, would be low. In contrast, four of the five demoralization factors suggest that random searches do not impose significant demoralization costs. Many, if not most, people have been stopped at some sort of checkpoint. The costs imposed appear necessary; everyone understands how these searches prevent crimes. The benefits of the burdens—less crime—accrue to everyone, including those who are stopped. It seems likely that very few people support crime, terrorism, or drunk driving, and most people probably think that preventing these is an acceptable, even valuable, role for the government to play.

3. *Benefits and Compensation*

There are essentially no benefits to a particular individual if he, instead of someone else, is selected to be searched. That is, while an individual may benefit if checkpoint searches reduce crime, and while a police presence in a particular area may (or may not) provide an individual with a sense of security, it does not benefit that individual in particular to be the subject of a checkpoint search. Nonetheless, although the costs to an individual of being the subject of a checkpoint search likely outweigh the benefits to him, federal, state, and local governments generally do not provide monetary compensation to individuals who are randomly selected for checkpoint searches.

4. *Insurance*

No insurance is available specifically for costs imposed by checkpoint searches, presumably because the costs are so low and the chances of being

¹⁵¹ *United States v. Green*, 293 F.3d 855, 860 (5th Cir. 2002).

stopped so small that nobody would pay for such insurance. It might also be argued that because the only type of significant cost related to checkpoint stops would be emotional costs, health insurance that pays for psychiatric care or counseling obviates any need for checkpoint-specific insurance.

B. *Jury Service*

1. *Randomness*

An individual's jury service is in part randomly determined because the pool of individuals from which a jury is chosen is randomly selected, and this randomness is generally thought to increase fairness. For example, members of about twenty professions, including attorneys and undertakers, used to be automatically excused from jury service in New York State courts. Presumably professions were added to the exemption list through some combination of special pleading, inside connections, and a belief that members of these professions were too valuable in their day-to-day jobs to be wasted on jury duty. But New York Court of Appeals Chief Judge Judith Kaye repealed many automatic exemptions, in part, she explained, "to spread the burdens and benefits of jury duty more equitably."¹⁵² Again, increasing randomness and reducing individualized treatment increased fairness *ex ante*.¹⁵³

2. *Costs*

The direct financial costs of serving on a jury are minimal, and may include the cost of transportation to the courthouse, parking, and perhaps a meal or two (assuming one would otherwise not be paying for any of these items). The opportunity costs differ depending on what type of job the potential juror holds and where the juror lives. Individuals cannot be fired for taking time off work to serve on a jury.¹⁵⁴ People who earn salaries, and not hourly wages, generally do not lose any pay for serving on a jury, and are not required to use vacation time for jury service, although they may suffer other opportunity costs, such as inability to attend an important

¹⁵² David Rohde, *Jury Duty Loses Some Sting in Manhattan*, N.Y. TIMES, Aug. 27, 1998, at B1, available at LEXIS, News Library, NYT File.

¹⁵³ Justice Marshall argued that fairness required that peremptory challenges be eliminated, which would have increased the randomness of jury selection, but his concern appeared to be with the rights of defendants, not with the costs imposed on jurors. See *Batson v. Kentucky*, 476 U.S. 79, 103 (1986) (Marshall, J., concurring) (stating that peremptory challenges have been used to exclude blacks from juries).

¹⁵⁴ See, e.g., 28 U.S.C. § 1875(a) (2006) ("No employer shall discharge, threaten to discharge, intimidate, or coerce any permanent employee by reason of such employee's jury service, or the attendance or scheduled attendance in connection with such service, in any court of the United States."); KAN. STAT. ANN. § 43-173(a) (2006) ("No employer shall discharge or threaten to discharge any permanent employee by reason of such employee's jury service, or the attendance or scheduled attendance in connection with such service, in any court of Kansas.").

meeting. On the other hand, people who earn hourly wages are generally not paid for the days they spend on jury service.¹⁵⁵

The emotional costs of jury service vary. There are not necessarily emotional costs to serving on a jury, although the experience may, like any experience, be unpleasant. How unpleasant jury service will be might depend on the nature of the case (e.g., whether the juror has to view unpleasant evidence), the length of the case, whether the jury is sequestered, whether the other jurors are difficult individuals, and so forth.

Uncompensated jury service might create moderate demoralization costs. Many people are selected for jury service at some point.¹⁵⁶ Because jury service in this country is by definition imposed upon citizens in general, the cost of serving on a jury cannot be avoided if the system is to exist. The benefits of jury service may accrue to the jurors themselves. As discussed below,¹⁵⁷ there may be benefits to jurors from serving on a particular jury, and the existence of a jury system may help those jurors later, if they or someone they are close to is accused of a crime. Finally, most people support the idea of a jury system.¹⁵⁸ However, the cost of compensation for jury service, including administrative costs, would likely be low, and the costs of service here are non-negligible, as opposed to the costs of being stopped at a checkpoint, which might tend to increase demoralization costs.

3. *Benefits and Compensation*

There may also be benefits to serving on a jury. The experience itself may be interesting, or exciting, or the juror may learn something about the American system of justice.¹⁵⁹ A juror in a particularly prominent case might gain a certain amount of notoriety, if he so desires.¹⁶⁰ And some people may take pleasure in exercising a political right that is partially

¹⁵⁵ See, e.g., Jake Levy-Pollans, *If Crime Doesn't Pay, Neither Does Jury Duty*, MINNPOST.COM, July 23, 2008, available at http://www.minnpost.com/community_voices/2008/07/23/2661/if_crime_doesnt_pay_neither_does_jury_duty.

¹⁵⁶ Evan R. Seamone, *A Refreshing Jury COLA: Fulfilling the Duty To Compensate Jurors Adequately*, 5 N.Y.U.L. LEGIS. & PUB. POL'Y 289, 291 n.2 (2002) (stating that various studies show that between sixteen and twenty-nine percent of Americans serve as jurors at some point).

¹⁵⁷ See *infra* text accompanying notes 159–62.

¹⁵⁸ According to a 2004 Harris Interactive poll, seventy-five percent of Americans would want their case to be decided by a jury, rather than a judge, and eighty-four percent of Americans think jury duty is an “important civic duty that should be fulfilled.” AMERICAN BAR ASSOCIATION, JURY SERVICE: IS FULFILLING YOUR CIVIC DUTY A TRIAL?, (July 2004), available at <http://www.abanet.org/media/releases/juryreport.pdf>.

¹⁵⁹ See, e.g., D. GRAHAM BURNETT, *A TRIAL BY JURY* 13 (2002).

¹⁶⁰ E.g., MICHAEL KNOX & MIKE WALKER, *THE PRIVATE DIARY OF AN O.J. JUROR* ix (1995); Denis Collins, *My 15 Minutes, All Because of Scooter*, WASH. POST, Mar. 11, 2007, at B1, available at LEXIS, News Library, WPOST File (“When I finished talking to the media that first morning after our verdict [finding I. Lewis “Scooter” Libby guilty of perjury], I knew that would not be the end of the story Let’s be honest, I was ready to be seduced [by the media].”).

constitutive of what it means to be a citizen,¹⁶¹ a right that was either *de facto* or *de jure* denied to many people in this country for many years.¹⁶²

In addition to these more abstract benefits, jurors are generally compensated for their service. All states and the federal government provide some token payment to jurors, ranging from ten dollars a day to fifty dollars a day. Over half the states and the federal government also reimburse jurors for certain travel expenses.¹⁶³ These amounts probably cover baseline out-of-pocket costs, though they may not cover jurors' actual out-of-pocket costs, for at least three reasons. First, no state compensates jurors based on what the jurors actually spend, though some states require receipts in order to obtain the baseline amount for parking expenses, for example. If a juror decided to go out to a very expensive lunch on the day of his jury service, perhaps because the courthouse was close to a fancy restaurant, he would not be able to turn in his receipt and have the state pay him for that lunch. Second, no state attempts to compensate at a flat rate based on the highest amount a juror could spend on basic needs such as meals or transportation, even though jurors may be accustomed to having very expensive lunches, or may drive cars that get very low gas mileage.¹⁶⁴ Finally, the flat daily compensation is not enough

¹⁶¹ See, e.g., AKHIL REED AMAR, *THE BILL OF RIGHTS* 216-18 & 217 n.*, 258-66 & 260 n.* (1998); Vikram D. Amar, *Jury Service as Political Participation Akin to Voting*, 80 CORNELL L. REV. 203, 239 (1995) (explaining that jury service is as much a part of the "package" of political rights as is voting); see also Sarah B. Lawsky, Note, *A Nineteenth Amendment Defense of the Violence Against Women Act*, 109 YALE L.J. 783, 788 & n.29 (2000) (indicating that political rights include the right to serve on a jury).

¹⁶² U.S. Supreme Court cases attempting to eliminate such discrimination provide both descriptions of the discrimination and a timeline of when such discrimination was finally struck down as unconstitutional. See *J.E.B. v. Alabama ex rel. T.B.*, 511 U.S. 127, 129 (1994) (holding that peremptory challenges may not be used to exclude jurors based solely on their gender); *Batson v. Kentucky*, 476 U.S. 79, 95 (1986) (holding that peremptory challenges may not be used to exclude jurors based solely on their race); *Taylor v. Louisiana*, 419 U.S. 522, 537 (1975) (striking down as unconstitutional a statute excluding women from juries); *Strauder v. West Virginia*, 100 U.S. 303, 312 (1880) (striking down as unconstitutional a law excluding blacks from juries).

¹⁶³ 28 U.S.C. § 1871 (2006) (stating that federal jurors are to be compensated forty dollars a day, but may, at the discretion of the judge, be paid an additional ten dollars a day for each day of the trial in excess of thirty days, in the case of a petit juror, or each day of service in excess of forty-five days, for a grand juror, and providing for travel and parking expenses); GREGORY E. MIZE ET AL., *THE STATE-OF-THE-STATES SURVEY OF JURY IMPROVEMENT EFFORTS* 11-12 (2007) (discussing state juror compensation). A 2007 study found that flat rates set at the state level ranged from \$10 a day (Alabama) to \$41.20 a day (New Mexico). Other states employ a graduated rate, and pay nothing or very little for the first several days, but pay a higher rate beginning on a later day of service. For example, Connecticut pays a juror nothing for his first five days of service, but beginning on the sixth day he receives \$50 a day. Other states, such as Montana, pay sworn jurors only. Finally, some states set a state minimum compensation but permit counties to supplement that rate. For example, Georgia mandates a state minimum rate of \$5, but the average rate is around \$24, because counties choose to supplement the state base rate. *Id.*

¹⁶⁴ The median reimbursement in 2007 was \$0.325 per mile. MIZE ET AL., *supra* note 163, at 11. The average price of a gallon of gas in June 2007 was about \$3.06. Energy Information Administration, U.S. Regular All Formulations Retail Gasoline Prices, http://tonto.eia.doe.gov/dnav/pet/pet_pri_gnd_a_epmr_pte_cpgal_m.htm (last visited July 6, 2008). Someone who chose to drive, say, a Lamborghini to jury service (a Lamborghini gets about eight miles to a gallon in city

to cover other out-of-pocket costs, such as daycare, that may be unavoidable for some jurors.¹⁶⁵ While the basic flat rate may cover out-of-pocket costs, it is not enough to cover opportunity costs such as lost wages.¹⁶⁶ Generally, employers are not required to pay employees for days missed due to jury service. Similarly, jury compensation payments do not take into account emotional costs.

4. *Insurance*

There is no separate market for jury insurance, that is, insurance an individual might buy separately to cover his costs in case he is called for jury service. It is not clear whether this is due to a lack of desire for jury insurance, or some type of market failure. It may be a combination of both, because jury insurance is built into some jobs. Salaried workers are not docked pay or vacation days for attending jury service, and some union contracts for hourly workers include jury pay provisions.¹⁶⁷ Thus, some employers provide opportunity-cost jury insurance just as they fully or partially sponsor other types of insurance for their employers. But some individuals who are paid by the hour and do not belong to a union, or belong to a union that is not particularly powerful, do not have access to jury insurance.

C. *Military Service*

1. *Randomness*

As with jury service, whether an individual serves in the military has at times been determined randomly, at least in part, as the pool of individuals who will be further investigated individually for their fitness to serve in the military has in the past been randomly selected. Indeed, in response to objections that the draft unfairly favored the wealthy, Congress amended the law so that individuals had fewer opportunities to plead special

driving) would thus not be fully compensated for his fuel costs. U.S. Dep't of Energy, 2008 Most and Least Fuel Efficient Vehicles, <http://www.fueleconomy.gov/feg/best/bestworstNF.shtml> (last visited July 6, 2008).

¹⁶⁵ A juror may be excused if her jury service would cause too much of a hardship for her, but generally she must go to the courthouse for at least one day in order to be excused. *See, e.g.*, U.S. Courts, Juror Qualifications: Exemptions and Excuses, <http://www.uscourts.gov/jury/qualifications.html> (last visited Sept. 1, 2008).

¹⁶⁶ An individual working full time and earning minimum wage makes at least forty dollars a day, before taxes (if any). *See* 29 U.S.C. § 206, as amended by the U.S. Troops Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, Pub L. No. 110-28, § 8102 (stating that federal minimum wage was raised to \$5.85 as of July 24, 2007). There is one notable exception: Arizona has a "Lengthy Trial Fund" which it uses to compensate jurors up to \$300 per day for lost wages, retroactive to the fourth day of trial, if the trial lasts at least six days. *MIZE ET AL.*, *supra* note 163, at 12.

¹⁶⁷ *See, e.g.*, AGREEMENT BETWEEN THE REEDY CREEK IMPROVEMENT DISTRICT AND THE REEDY CREEK FIREFIGHTERS ASSOCIATION IAFF LOCAL 2117 43 (2004), available at http://www.reedycreek.org/pdf/2004-2006_contract.pdf.

circumstances and escape conscription.¹⁶⁸ For example, before the law was amended, students could defer service by showing that they were in school full time and making “satisfactory progress toward a degree.”¹⁶⁹ Under current law, if the draft is enacted, a college student could postpone service only until the end of the current semester (or, in the case of a senior, until the end of the current academic year).¹⁷⁰ In other words, to increase fairness, Congress increased randomness.

2. *Costs*

Serving in the military imposes significant costs. It imposes essentially no direct financial costs, as individuals do not pay out of pocket to join the military. The opportunity costs, though, range from the substantial to the infinite. At the very least, an individual who is inducted into the military will lose the years he could have spent doing another job and the money he could have earned from that job. At the other extreme, an individual who is drafted could be killed while serving. Serving in the military also increases one’s chances of becoming severely disabled, thereby reducing one’s lifetime earning power. Emotional costs of serving in the military may also be substantial.

Demoralization costs in this context would likely vary widely. A military draft could be widespread, or it could be relatively narrow, depending on how many men were needed for service. The costs of compensation for military service are always high because the costs to an individual of military service are high. The conflict in which the government is involved, and thus the need for military service, might seem reasonable (for example, most people eventually agreed that the United States should be involved in World War II), or it might seem unreasonable or unnecessary (for example, opinion is split on whether the United States should have invaded Iraq). Some people serving in the military will benefit from that service, but others might not, and some conflicts may seem to serve only the interests of a select group of citizens, as opposed to benefiting all citizens. And while some people support all applications of the underlying governmental function of raising a military, others might be pacifists, opposed to the military in general, or opposed to the specific conflict for which the draft was instituted.

3. *Benefits and Compensation*

On the other hand, serving in the military can be highly beneficial.

¹⁶⁸ See Selective Serv. Sys., How the Draft Has Changed Since Vietnam, <http://www.sss.gov/viet.htm> (last visited July 8, 2008) (“A series of reforms during the latter part of the Vietnam conflict changed the way the draft operated to make it more fair and equitable. If a draft were held today, there would be fewer reasons to excuse a man from service.”).

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

Setting aside any government compensation for service, the actual service itself may provide an individual with structure or training he might not have obtained otherwise, and military service can be a full and rewarding career. As with serving on a jury, an individual may appreciate exercising a political right that is partially constitutive of what it means to be a citizen.¹⁷¹

The government provides substantial compensation for serving in the military in addition to these other benefits. Active duty military receive a salary, low-cost housing, medical care for themselves and their families, and many other benefits.¹⁷² Veterans may receive pensions, tuition assistance, and medical care.¹⁷³ Disabled veterans receive military disability payments.¹⁷⁴ The tax code provides incentives for private employers to hire certain veterans, which means the government essentially subsidizes part of some veterans' private-sector salaries.¹⁷⁵ Federal and state governments give veterans preferences for certain jobs in order to compensate the veterans for "economic loss" they suffered due to their service.¹⁷⁶

¹⁷¹ See *supra* note 161 and accompanying text.

¹⁷² See, e.g., Benefits for Service Members, <http://www.defenselink.mil/militarypay/benefits/militaryben.pdf> (last visited July 8, 2008).

¹⁷³ See, e.g., Gerald A. Williams, *A Primer on Veterans' Benefits for Legal Assistance Attorneys*, 47 A.F.L. REV. 163, 163 (1999); U.S. DEP'T OF VETERANS AFFAIRS, A SUMMARY OF VA BENEFITS (2004), available at <http://www.vba.va.gov/VBA/benefits/factsheets/general/21-00-1.pdf>.

¹⁷⁴ See, e.g., Williams, *supra* note 173, at 163; U.S. DEP'T OF VETERANS AFFAIRS, DISABILITY COMPENSATION BENEFITS (2007), available at <http://www1.va.gov/opa/vadocs/fedben.pdf>.

¹⁷⁵ I.R.C. § 51 provides a tax credit to businesses equal to forty percent of a "qualified veteran's" first-year wages, up to \$12,000 a year. In other words, the federal government pays up to \$4800 of a "qualified veteran's" first-year wages. A qualified veteran for these purposes is a veteran who is a member of a family that has received food stamps for at least three months in the year prior to the veteran's hiring, or is entitled to compensation for a service-connected disability and either is hired no more than one year after discharge from active duty, or has been unemployed for an aggregate of at least six months in the year prior to hiring. I.R.C. § 51(d)(2)(A). Employers get work opportunity credits for other types of employees as well (for example, certain ex-felons or food stamp recipients), but the amount of wages with respect to each individual that may be taken into account for the credit is only \$6000, as opposed to \$12,000 for qualified veterans. I.R.C. § 51(b)(3).

¹⁷⁶ See, e.g., U.S. Office of Personnel Mgmt., VetsInfo Guide: Civil Service Employment and Veterans, <http://www.opm.gov/veterans/html/vetsinfo.asp> (last visited July 10, 2008) ("Since the time of the Civil War, veterans of the Armed Forces have been given some degree of preference in appointments to Federal jobs. Recognizing their sacrifice, Congress enacted laws to prevent veterans seeking Federal employment from being penalized for their time in military service. Veterans' preference recognizes the economic loss suffered by citizens who have served their country in uniform, restores veterans to a favorable competitive position for Government employment, and acknowledges the larger obligation owed to disabled veterans. Veterans' preference is not so much a reward for being in uniform as it is a way to help make up for the economic loss suffered by those who answered the nation's call to arms."); Kansas Civil Serv. Jobs, Veterans Preference, <http://da.ks.gov/ps/aaa/recruitment/veterans.htm> (last visited July 10, 2008) ("In recognition of the sacrifices made by those serving in the Armed Forces, the State of Kansas enacted laws to prevent veterans seeking State employment from being penalized because of time spent in military service. Veterans' preference recognizes the economic loss suffered by citizens who have served their country in uniform, restores veterans to a favorable competitive position for Government employment. Veterans' preference is not so much as a reward for being in uniform as it is a way to help make up for the economic loss suffered by those who answered the nation's call to arms."); Military.com Benefits, New York State Veteran's

However, if an individual is drafted, he clearly feels, at least before he experiences military service, that the monetary compensation together with other benefits offered by the military do not outweigh the expected costs of service for him. If he did feel that the benefits of his service outweighed his expected costs, presumably he would have willingly signed up for military duty, instead of being drafted. In other words, while the government does provide considerable compensation for military service, drafted individuals likely do not receive full compensation for their service.¹⁷⁷

4. *Insurance*

Notwithstanding that those drafted may not feel fully compensated for their military service, no opportunity cost insurance has traditionally been available for those who might be drafted. The military does offer low-cost life insurance for the families of service members, but no insurance is, or has been, available to provide cash compensation for opportunity costs to service members who survive military service. Again, it is not clear whether this reflects a lack of desire for such insurance, given the substantial benefits ostensibly provided veterans, or some type of market failure.

Benefits, <http://www.military.com/benefits/veteran-benefits/new-york-state-veterans-benefits> (last visited July 10, 2008) (stating that with regard to state and local civil service jobs, there would be a “[t]en-point additional credit preference toward original appointment for disabled wartime veterans; five-points for wartime service; and two and a half points for competitive promotional exams. Job retention rights applicable to veterans and spouses of totally disabled veterans”); see also *Pers. Adm’r of Mass. v. Feeney*, 442 U.S. 256, 261, 265 (1979) (stating that “[t]he Federal Government and virtually all of the States grant some sort of hiring preference to veterans” in order to “reward veterans for the sacrifice of military service, to ease the transition from military to civilian life, [and] to encourage patriotic service”).

¹⁷⁷ This may be, at least in part, because the benefits that the government ostensibly provides may be less than they initially seem. For example, veterans benefits may be difficult to obtain, and health care provided both to veterans and to active-duty military may be severely lacking. See generally *Traumatic Brain Injury Access to Options Act*, S. 1113, 110th Cong. (2007) (requiring that members of the Armed Forces who incur traumatic brain injury while on active duty be retained on active duty in the Armed Forces for one year after the medical assessment of their ability to perform certain activities, in order to prevent transfer to the VA system); William F. Fox, Jr., *Deconstructing and Reconstructing the Veterans Benefits System*, 13 KAN. J.L. & PUB. POL’Y 339 (describing problems with the veterans benefits system); INDEP. REVIEW GROUP, *REBUILDING THE TRUST: REPORT ON REHABILITATIVE CARE AND ADMINISTRATIVE PROCESSES AT WALTER REED ARMY MEDICAL CENTER AND NATIONAL NAVAL MEDICAL CENTER* (2007), available at http://www.npr.org/documents/2007/apr/walter_reed/executive.pdf (finding extensive failures in health care for both active-duty military and veterans); Press Release, Sen. Hillary Rodham Clinton, Bayh, Clinton Call on Secretaries Gates and Nicholson to Immediately Address Care for Troops with Traumatic Brain Injury (July 10, 2008), available at <http://clinton.senate.gov/news/statements/details.cfm?id=272376&&> (“Most problems with care have occurred when soldiers suffering from TBI [traumatic brain injury] have been transferred from active duty status to medically retired, where they can no longer access private care centers and must receive treatment through the VA, which currently lacks comprehensive treatment for TBI patients.”).

D. *Random Audits: A Comparison*

1. *Costs*

As discussed above,¹⁷⁸ a taxpayer may incur direct financial costs if he is selected as the subject of a random audit, including paying an accountant or attorney to represent him. Random audits may also create opportunity costs. If a taxpayer hires someone to represent him, the audit should take only a moderate amount of his time, perhaps time spent gathering receipts and documentation, meeting with his representative two or three times, and meeting once with the auditor. These opportunity costs should be more than the opportunity costs, if any, of a checkpoint stop, somewhat less than the opportunity costs of an average jury trial, and far less than the opportunity costs of compelled military service.

The emotional costs of audits may be high. Random audits as currently conceived are fairly invasive. As discussed above, most individuals selected for the current round of random audits will meet in person with IRS auditors to confirm specific lines of their returns, which will probably involve reviewing many of the taxpayer's financial documents and questioning the taxpayer about specific expenditures to determine, for example, whether the taxpayer's deductions really were for business expenses. This seems more like a physical search of one's house, and less like a police officer patting an individual's bag in a public place or waving a magnetometer over an individual, but again, far less than the possible emotional costs of military service.

Demoralization costs of random audits may be high. Unlike the many who are selected for jury service or checkpoint stops, very few people are selected for random audits, and so those selected may feel particularly disfavored. Depending on whether people understand random audits and DIF scores (and it seems likely that people understand very little about either of these), the costs imposed by random audits appear unnecessary. Furthermore, it is not clear what benefits are created by these audits at all, much less whether any benefits accrue to the subject of the audit. And while people may support the government's preventing crime or stopping drunk drivers, and may like that the United States has a jury system, many people hate paying taxes and the tax system.¹⁷⁹

¹⁷⁸ See *supra* Part II.B.

¹⁷⁹ Most people either "dislike" or "hate" doing their income taxes (66%, according to an April 2001 Gallup/CNN/USA Today poll; 70%, according to a March-April 2005 Harris Interactive/Tax Foundation poll). In 1983, 51% of taxpayers viewed the IRS favorably; in 2001, 46% did. The IRS was the lowest-ranked of twenty federal agencies. The next lowest were the CIA and the Bureau of Land Management, each with 49% favorable. For comparison, the National Park Service had an 80% favorable rating; the FBI, 59%; and the Postal Service, 78%. AEI STUDIES IN PUBLIC OPINION, PUBLIC OPINION ON TAXES 1 (2008), available at <http://www.aei.org/publicopinion6>.

2. *Benefits and Compensation*

Paying taxes, like jury service and military service, may also be an element of citizenship and a civic responsibility.¹⁸⁰ One version of civic republicanism argues that while no citizen should be denied the right to serve on a jury, or serve in the military, neither should a citizen be able to choose not to live up to the responsibility of citizenship by refusing to serve on a jury or refusing to serve in the military.¹⁸¹ An effective tax system requires some type of enforcement, so bearing audit costs that permit a tax system to keep working may also be a civic responsibility—one best spread by selecting individuals at random to bear these costs.¹⁸²

Audits are unlike military service and jury duty, though, and more like a checkpoint search in that an individual taxpayer is unlikely to gain any benefit from an audit, whereas it is possible that an individual might come to appreciate serving, or having served, in the military or on a jury.¹⁸³ In part this is because the actual experience of an audit is inherently less of a learning experience than either military or jury service, especially if a taxpayer hires someone to handle the audit for him, something that is currently impossible to do with military or jury service.¹⁸⁴

¹⁸⁰ See, e.g., *O'Malley v. Woodrough*, 307 U.S. 277, 278–79, 282 (1939) (upholding as constitutional a law taxing the income of federal judges, the Court noted: “To subject [judges] to a general tax is merely to recognize that judges are also citizens, and that their particular function in government does not generate an immunity from sharing with their fellow citizens the material burden of the government whose Constitution and laws they are charged with administering.”); BRUCE ALLEN MURPHY, *WILD BILL: THE LEGEND AND LIFE OF WILLIAM O. DOUGLAS* 183 (2003) (quoting Justice Douglas as saying, regarding his vote in *O'Malley v. Woodrough* to make Justices' salaries taxable, “As I made the little entry into the docket sheet I said to myself, ‘Young man, you’ve just voted yourself first-class citizenship.’ I decided that, if we were going to pay taxes like everybody else, that you should be a citizen like everybody else, except that unless the thing you are doing interferes with the work on the Court.”); Guttman, *supra* note 1 (stating that Lawrence Gibbs, the only former IRS commissioner known to have been the subject of a TCMP (random) audit, views TCMP audits as “part of a taxpayer’s obligation as a citizen, similar to the draft”); Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 468 (2000) (arguing that “one of [the responsibilities of citizenship] is the obligation to participate in the funding of public goods by paying an appropriate share of their cost”); Lawrence Zelenak, *Justice Holmes, Ralph Kramden, and the Civic Virtues of a Tax Return Filing Requirement*, 61 TAX L. REV. 53, 60 (2007) (arguing that paying taxes and voting are “the two great responsibilities of citizenship”).

¹⁸¹ See *supra* note 161.

¹⁸² Unlike military service or jury duty, there is no further individual investigation to determine whether an individual will actually be audited, but this makes sense, because some people will make better soldiers, or better jurors, than others, whereas everyone is equally suited to be randomly audited by the IRS. See, e.g., NEIL DUXBURY, *RANDOM JUSTICE* 156 (1999) (“A basic problem with selecting conscripts by way of a draft lottery is that some of the most able and willing soldiers will not be picked.”).

¹⁸³ But see Guttman, *supra* note 1 (stating that Lawrence Gibbs, the only former IRS commissioner known to have been the subject of a TCMP random audit, felt that “his TCMP audit taught him how to better organize his records”); cf. Zelenak, *supra* note 180, at 60 (arguing that tax compliance is a civic virtue, and that paying taxes is “an important civic activity [that] demands a ceremony, and the filing of one’s tax return is that ceremony”).

¹⁸⁴ During the Civil War, men who were drafted into the Union Army could pay the government a \$300 “commutation” that would exempt them from service. Michael S. Satow, *Consientious Objectors*:

The government compensates individuals for military service and jury duty. Compensation for random audits would be more on the scale of jury duty compensation, as opposed to the massive benefits ostensibly provided to service members and veterans. Individuals do not receive full compensation for their jury service, however. Full compensation for random audits could be extremely expensive if the government attempted to compensate individuals for all costs of random audits, including actual out-of-pocket costs, opportunity costs, and perhaps even emotional costs. Reimbursing taxpayers for their actual expenditures, as opposed to flat-rate compensation, would also create large administrative costs.¹⁸⁵

* * * *

The following chart summarizes the discussion so far:

	Checkpoints	Jury	Military	Audit
Costs				
<i>To Individual</i>				
Direct financial (out-of-pocket)	None	Small	None	Medium
Indirect financial (opportunity)	None	Medium	Large	Small/ Medium
Emotional	Medium	Varies	Large	Medium
Demoralization	Small	Small	Varies	Medium/ Large
<i>To Others</i>				
Demoralization	Small	Medium	Varies	Medium/ Large
Benefits (except compensation)				
<i>To Individual</i>	Small	Medium	Large	Small
<i>To Others (as a group)</i>	Large	Large	Large	Large
Compensation	None	Small (baseline out-of-pocket)	Large	None (currently)

These are, of course, merely comparative, order-of-magnitude estimates. Depending on a person's job, for example, a long jury trial could present significant opportunity costs, or none at all (if the person is retired). Emotional costs of course would vary widely among individuals—a checkpoint stop could present no emotional cost to one person and be nearly traumatic to another. Moreover, it is unclear how one

Their Status, the Law, and Its Development, GEO. MASON U. CIV. RTS. L.J. 113, 115 (1992). The World War I draft included no such exception. *Id.* at 117.

¹⁸⁵ For example, the NRP that began in 2007 will examine approximately 13,000 returns a year. See *supra* note 28. As discussed *supra* note 41, a taxpayer's out-of-pocket costs alone could range as high as \$25,000 per audit. This suggests that the total cost of the compensation program could be several hundred million dollars, including administrative costs.

would compare, say, “medium” emotional costs with “medium” direct financial costs, because it is not clear how (if at all) one could monetize emotional costs.¹⁸⁶ Finally, even if it were possible to get a correct estimate for each type of cost, and to monetize emotional and demoralization costs, the result for the appropriate amount of compensation would still depend on the utility curve and social welfare function selected.

Notwithstanding these limitations, the comparison between random audit costs and other randomly imposed burdens suggests that perceived unfairness created by random audits should be mitigated by some compensation, but not by full compensation, where full compensation would include compensation for actual out-of-pocket expenditures, all opportunity costs, and all emotional costs. If demoralization costs can be eliminated or reduced by nominal compensation, some amount of compensation for random audits might be particularly desirable. This is especially true if demoralization costs stemming from the perception of unfairness in fact result in lower compliance by taxpayers in general, as opposed to the targeted taxpayer.

Compensation might not be the only way to reduce demoralization costs in the tax context, though; education may help as much or more. Factors that seem to increase the demoralization costs of random audits include taxpayers’ belief that random audits are unnecessary, taxpayers’ belief that they obtain no benefit from random audits in particular or a functioning tax system in general, and taxpayers’ general dislike of the tax system.¹⁸⁷ If nominal compensation were accompanied by a campaign to explain the purpose of random audits and the ways that taxpayers are selected for audit, as well as a general campaign to popularize taxes, and the Internal Revenue Service in particular, demoralization costs could be reduced substantially.¹⁸⁸ But these issues are unrelated to randomness. As the discussion of checkpoints, jury service, and military service suggests, randomness need not be associated with unfairness, even when this randomness comes in the form of the government’s selecting individuals at random to bear costs for the benefit of society at large.

VI. CONCLUSION

This Article examines one aspect of whether taxpayers who are

¹⁸⁶ This is an extremely complex issue within welfarism, and is far beyond the scope of this Article.

¹⁸⁷ See *supra* text accompanying note 179.

¹⁸⁸ This would not be unprecedented; the United States engaged in a massive and successful propaganda campaign to popularize the income tax during World War II. See generally Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685 (1988).

randomly selected for audit should, as some academics and politicians have suggested, be compensated for their audit costs.¹⁸⁹ An egalitarian analysis of randomly imposing audit costs suggests that if the insurance market is working properly, fairness does not require the government to compensate individuals for these costs, because individuals are able to purchase insurance if they choose, and are not required to participate in a government insurance scheme. Fairness may, however, require the government to compensate low-income taxpayers for whom the market for audit insurance has failed.

Even though it is generally fair for the government not to compensate taxpayers for randomly imposed audit costs, taxpayers may still perceive this lack of compensation as unfair. This perceived unfairness should matter to a welfarist, because people prefer to comply with laws, including tax laws, that they perceive to be fair.

In particular, if randomly imposing audit costs on a few individuals for the good of the whole is seen as unfair and thus creates demoralization costs, compensating taxpayers for these randomly imposed audit costs may reduce social costs and increase compliance. A comparison between random audits and other random costs suggests that nominal compensation, not full compensation, may be the best approach, and that education about the tax system may complement this compensation to decrease demoralization costs even further.

As discussed above, there may be reasons other than fairness, such as calibrating marginal audit costs and benefits, to compensate taxpayers randomly selected for audit.¹⁹⁰ And, as this Article has argued, the government might wish to mitigate perceived unfairness of random audit costs by providing nominal compensation for these costs. But this perceived unfairness is not due simply to randomness, and therefore general appeals to fairness that equate random costs with unfair costs should not be used to support such compensation.

* * * *

By way of epilogue, let us return to Senator Paul Coverdell of Georgia.¹⁹¹ Closer inspection suggests that Senator Coverdell's objections to putatively random audits may not have been objections to randomness at all. He did not, after all, propose his anti-randomness legislation because he objected to random audits in the abstract; he proposed that legislation because his constituents had been targeted disproportionately—that is,

¹⁸⁹ See *supra* notes 1, 36–39 and accompanying text.

¹⁹⁰ See *supra* Part II.B.

¹⁹¹ See *supra* text accompanying notes 34, 110.

nonrandomly—due to specific IRS projects.¹⁹² As Coverdell stated before Congress, “the IRS has been specifically targeting the State of Georgia for random audits. Nearly twice as many random audits took place in Georgia between 1994 and 1996 than in all the New England states combined and Georgians are three-times more likely to be randomly audited than their California counterparts.”¹⁹³

In other words, although on one level there was too much randomness, Coverdell’s complaint was actually triggered by too little randomness. In 1995, somewhat less than three percent of the total population of the United States lived in Georgia, so even a relatively large truly random audit of U.S. taxpayers would probably have involved only a very small number of Georgians.¹⁹⁴ Thus, had these audits actually been random, random audits may well have escaped Senator Coverdell’s scrutiny altogether.

¹⁹² IRS’ USE OF RANDOM SELECTION, *supra* note 12, at 2 (noting, in response to an inquiry from Senator Coverdell, that the “IRS chose the subpopulations for the six projects nonrandomly on the basis of known or suspected high noncompliance rates and other criteria, including geographic location or business size Three of the six projects included taxpayers from Georgia”).

¹⁹³ 144 CONG. REC. S9212, S9235 (1998) (statement of Sen. Coverdell) (introducing the Internal Revenue Service Random Audit Prohibition Act); *see Senators Blast IRS*, *supra* note 33 (stating, while discussing random audits, that “you have three chances more of being audited in the State of Georgia than many of the other States”).

¹⁹⁴ According to the Census Bureau, approximately 2.7% of U.S. residents lived in Georgia in 1995. U.S. Bureau of the Census, U.S. Counties 1996, Geographic Area: Georgia, <http://www.census.gov/statab/USA96/13/000.txt> (stating that the population of Georgia in 1995 was 7,200,882) (last visited July 10, 2008); U.S. Census Bureau, Intercensal Estimates of the United States Resident Population by Age and Sex: 1995, <http://www.census.gov/popest/archives/EST90INTERCENSAL/US-EST90INT-07/US-EST90INT-07-1995.csv> (stating that the population of the United States on January 1, 1995, was 264,753,646) (last visited July 10, 2008). This proportion has increased—in 2006, it was about 3.1%. U.S. Census Bureau, State & County Quick Facts: Georgia, <http://quickfacts.census.gov/qfd/states/13000.html> (stating that as of 2006, there were an estimated 9,363,941 people living in Georgia and an estimated 299,398,484 people in the United States) (last visited July 10, 2008).