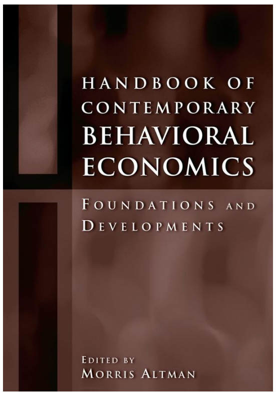

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Morris Altman

Taxation and the Contribution of Behavioral Economics

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PART 8

TAXATION, ETHICAL INVESTMENT, AND TIPPING

CHAPTER 29

TAXATION AND THE CONTRIBUTION OF BEHAVIORAL ECONOMICS

SIMON JAMES

Taxation has been the subject of a great deal of study in the tradition of neoclassical economics. By examining the rational self-interested response of individuals in different situations, mainstream economics has been able to provide a great deal of understanding of the effects of taxation in areas such as the supply of labor, saving, and enterprise. However, even in such clearly defined "economic" areas, behavioral economics can offer further insights and explanatory power beyond that provided by conventional economic theories. For example, even in modern times, labor market and household investment decisions might still be influenced by a range of social factors such as traditional gender roles (James 1992, 1995a, 1996).

In many areas of taxation—most notably tax compliance—behavioral economics has even more to offer in understanding taxpayer behavior and in developing appropriate policies and successful administrative strategies for their implementation. As an illustration of the importance of the behavioral contribution, this essay will concentrate on tax compliance. As will be shown, decisions about the extent to which taxpayers are willing to comply with the tax system can involve legal as well as illegal action. It also involves simple pecuniary incentives and disincentives as well as wider behavioral considerations regarding the fulfillment of obligations of various sorts.

The purposes of taxation are also relevant. Taxation is, of course, used to raise revenue, but it is also used to implement government policy by attempting to influence behavior through the use of tax concessions in some areas and additional taxation in others. Behavioral economics has a particular contribution to offer in assessing the likely effectiveness of such policies.

This essay begins with a brief history of the economics of taxation followed by a contrast between neoclassical and behavioral approaches to economics. The analysis then turns to the development of behavioral models and goes on to give an indication of the range of research methodology in the area. Behavioral economics is also examined specifically in the context of the purposes of taxation in order to show how the behavioral contribution might fit into a more general economic framework. It is clear from the study of behavioral economics that existing definitions of tax compliance are inadequate, and so a more relevant definition is developed. Revenue services have adopted behavioral models, and some of these applications of behavioral theory are summarized. Future possibilities for tax compliance research are outlined, and finally the essay presents some conclusions.

A BRIEF HISTORY OF THE ECONOMICS OF TAXATION

Taxation was extensively studied by the English classical economists such as Adam Smith. Many of them took account of behavioral factors as a matter of course. Indeed, Adam Smith's "four maxims" regarding taxation in general have become the starting point for many subsequent contributions over the years, and each of them has a behavioral dimension. The first two maxims relate to his view of the fairness of taxes and that taxes should be certain, not arbitrary. The third is that every tax "ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it." Finally, taxes "ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state" (Smith 1776, bk. V, ch. II, pt. II). Smith also indicates some of the psychological costs of taxation. In a memorable passage he says that "the odious examination of the tax gatherers" may cause taxpayers "much unnecessary trouble, vexation and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it" (ibid.).

David Ricardo devoted ten chapters of his *Principles* to problems of taxation and was also well aware of the importance of behavioral factors. For example, he stated that taxation, whether it was levied on capital or on income, would be paid from income because of the "desire which every man has to keep his station in life, and to maintain his wealth at the height which it has once attained" (Ricardo 1821, ch. VIII).

As a further illustration, in his famous comparison between direct and indirect taxation, John Stuart Mill stated that in England there had long been a popular feeling opposed to direct taxation such as income tax. He went on to say that this feeling "is not grounded on the merits of the case, and is of a puerile kind. An Englishman dislikes, not so much the payment, as the act of paying. He dislikes seeing the face of the tax-collector, and being subject to his peremptory demand." Mill went on to suggest that if the level of taxation remained the same but indirect taxes were incorporated into direct taxation "an extreme dissatisfaction would certainly arise . . . while men's minds are so little guided by reason" (Mill 1848, bk. 5, ch. 6).

As economics came to replace the old discipline of political economy in the twentieth century, such wider aspects of behavior were not usually included in more "scientific" economic analysis of taxation. Neoclassical economics became more focused than the classical economists had been, and there seemed to be less concern with why individuals behaved the way they did; the assumption was simply that they had acted on rational economic and self-interested criteria narrowly defined.

NEOCLASSICAL THEORY AND BEHAVIORAL ECONOMICS

There are many formulations of neoclassical theory. For example, Edgeworth was quite clear that "economics investigates the arrangements between agents each tending to his own maximum utility" (Edgeworth 1881, 6). Furthermore, the "first principle of Economics is that every agent is actuated only by self-interest" (1881, 16). As Jevons remarked, the "fearless manner in which Mr Edgeworth applies the conceptions and methods of mathematical physics to illustrate, if not solve, the problems of hedonic science, is quite surprising" (1881, 581). Edgeworth went on to apply his approach to taxation, stating, for example, that the "science of taxation comprises two main subjects to which the character of pure theory may be ascribed; the laws of incidence and the principles of equal sacrifice" (Edgeworth 1925, 64).

The approach to the analysis of human behavior on the ground of self-interest narrowly defined has always attracted powerful criticism. For example, Veblen (1898) was scathing in his description of the hedonistic conception of man. According to Veblen, this conception envisaged an individual as a "lightning calculator of pleasure and pains, unaffected by experience with neither antecedent nor consequent"—in other words, a purely passive, isolated, and "self-contained globule of desire." The arguments have been repeated and developed ever since. Although there seem to be two separate approaches, mainstream and behavioral economics, they are in many ways two contributions to the same study. Edwin Cannan put it well in writing that there "is no precise line between economic and non-economic satisfactions, and therefore the province of economics cannot be marked out by a row of posts or a fence like political territory or a landed property" (1946, 4).

Tax compliance is a major issue in ensuring that countries can fund without excessive costs and difficulties the high levels of public expenditure required by modern societies. As Jean-Baptiste Colbert is reputed to have said in the seventeenth century, the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.

There have been a number of surveys of the research literature relating to tax compliance, such as the recent one by Richardson and Sawyer (2001). As with other areas of economic study, it is easy to identify the two separate approaches to the study of compliance.

TAXPAYER COMPLIANCE AND ECONOMIC RATIONALITY

The neoclassical approach to tax compliance is based on a relatively narrow interpretation of economic rationality. It is supposed that totally amoral individuals maximize their utility by maximizing their income and wealth. They will evade tax if they consider that by doing so they can expect to increase their spending power. For example, according to Bernasconi, "evading tax is like gambling" and is perceived as an economic transaction like any other (1998, 123). Following this approach, compliance and noncompliance are simply explained by the money costs and benefits involved.

Allingham and Sandmo (1972) published a seminal and extensively quoted paper developing this approach, and there have been many refinements and developments of their model since. A particularly clear exposition of mainstream economic analysis of tax evasion was presented by Cowell (1985). This approach indicates a number of variables that are likely to be important in such a technical analysis of compliance. An important one is the tax structure—that is, the setting of tax rates—which may have a direct influence on compliance (Alm, Bahl, and Murray 1990; Clotfelter 1983). There has also been work on regressive taxes (Nayak 1978) and nonlinear tax schedules (Pencavel 1979). Other aspects that might affect the expected rate of return to noncompliance, such as uncertainty, have been examined (see, for example, Alm, Jackson, and McKee 1992).

There are also other obvious costs such as those of concealment (Cremer and Gahvari 1994). The chances of getting caught are important, so the probability of tax evasion being detected is relevant (Fischer, Wartick, and Mark 1992). So are the deterrent effects of auditing for noncompliance (Dubin and Wilde 1988) and the relative effects of different audit schemes (Alm, Cronshaw, and McKee 1993; Collins and Plumlee 1991). The analysis can, of course, be extended to other players in this game. Tax agents are important, so the whole approach can also be applied to them—for instance, the penalties that might be imposed on them (Cuccia 1994). Another such line of inquiry has focused on risk-averse tax collectors (Tzur and Kraizberg 1995). Finally, other related economic factors that might affect the decision-making process, such as inflation (Crane and Nourzad 1986), have also been studied.

The cost-benefit approach can also be extended to the possibility that compliance might be improved with pecuniary rewards to taxpayers (Falkinger and Walther 1991) as well as pecuniary punishments for noncompliance. After all, they are just two aspects of money incentives to conform.

However, this narrow "calculus of pleasure and pain," as described by Jevons (1871), does not seem to provide a full explanation of taxpayer behavior. For example, there is empirical evidence that many taxpayers are inherently honest and will disclose their financial affairs accurately regardless of the incentive to cheat (Erard and Feinstein 1994b; Gordon 1989). With respect to other taxpayers, deterrence theory suggests that there is a range of dimensions that influence behavior, apart from the risk of detection (Grasmick and Bursik 1990). A policy of treating the taxpayer as a social being rather than just an amoral fiscal gambler seems to justify more attention than perhaps it has received in policy areas to date. This is also important given the greater role self-assessment now plays in some tax systems (Barr, James, and Prest 1977; James 1995b).

THE DEVELOPMENT OF BEHAVIORAL MODELS

A behavioral approach to tax compliance has a great deal to offer in terms of supplementing and extending mainstream economic analysis. There are many contributions from different disciplines suggesting a range of other factors that might influence taxpayers' behavior. For instance, work in sociology has identified a number of relevant variables such as social support, social influence, attitudes, and certain background factors such as age, gender, race, and culture. Psychology reinforces this approach and has even created its own branch of "fiscal psychology" (Schmölders 1959; Lewis 1982). The contribution of psychology includes the finding that attitudes toward the state and revenue authorities as well as perceptions of equity are important factors in determining compliance decisions. Economic psychology also stresses the importance of attitudes, morals, values, and fiscal consciousness (Cullis and Lewis 1997). The roles of individuals in society and accepted norms of behavior have also been shown to have a strong influence (Wenzel 2001a, 2001b). Braithwaite (2003) examined such factors as the perception of justice and how social norms and laws can undermine each other.

The main theme of this approach is that individuals are not simply independent selfish utility maximizers (though this might be partly true); rather, they also interact with other human beings in ways that depend on different attitudes, beliefs, norms, and rules. It also means that as taxpayers, they normally can be expected to act as responsible citizens. That is, in normal circumstances, they should conform to reasonable obligations of the tax system without the extensive application of enforcement activity.

There are many detailed contributions to this approach, including some by economists. For example, Spicer and Lundstedt (1976) examined taxpayer norms and attitudes toward the tax system and tax offenders some time ago, and nonmaximizing behavior more recently (Spicer 1986). The importance of equity and fairness has also been a frequent theme (for example, Bordignon 1993 and Cowell 1992). Background factors such as cultural influence have been examined (Coleman and Freeman 1997), as have the implications of different political systems (Pommerehne, Hart, and Frey 1994). More direct contributions to policy in this area have come from a number of authors. For example, one is an appeal to taxpayers' conscience (Hasseldine and Kaplan 1992) and also to feelings of guilt and shame (Erard and Feinstein 1994a). Others have suggested more positive help for taxpayers (Hite 1989) and different methods of achieving this, such as the use of television to change taxpayers' attitudes toward fairness and compliance (Roberts 1994). It is also possible that taxpayers consider the benefits the community receives from government expenditures (Falkinger 1988). There may therefore be scope to improve compliance by drawing attention to the benefits of public spending.

Many more papers could have been cited, but this section gives an indication of the range of academic evidence that supports the behavioral approach.

RESEARCH METHODOLOGY

The main behavioral research methods used have been social surveys employing questionnaires and interviews—see, for example, the work of Williams (1966), Strümpel (1969), and Schmölders (1970). There are many examples specifically related to tax compliance. Yankelovich, Skelly, and White (1984) surveyed taxpayer attitudes. Christensen (1992) conducted a survey of tax clients and tax practitioners in order to compare their views of tax services. A third example is provided by Bain, Milliron, and Rupert (1997), who investigated the type of tax firm and the experience of the practitioner with respect to tax practitioner aggressiveness.

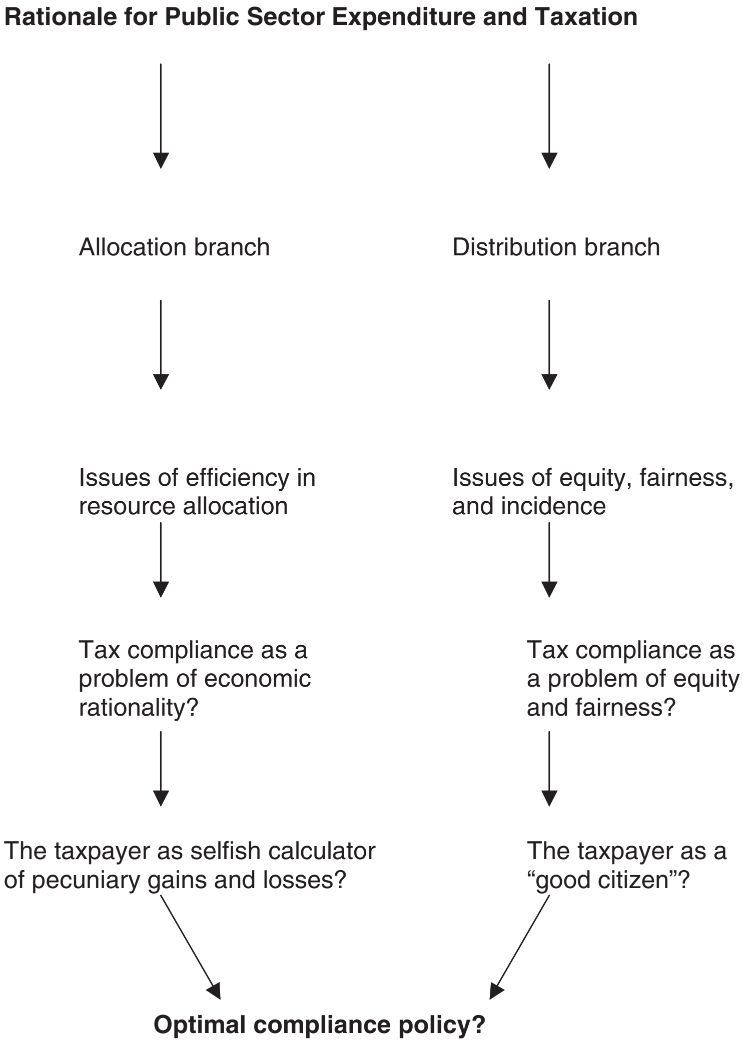
Experiments have also become increasingly used, for example, by Webley and colleagues (1991). A further example is that of Kaplan and colleagues (1988), who used an experimental study and found that experienced practitioners were not affected by variables such as the probability of audit, though inexperienced practitioners were. A notable contribution in this area was reported by Blumenthal, Christian, and Slemrod (2001) and Slemrod, Blumenthal, and Christian (2001). They describe a unique set of experiments conducted by the Minnesota Department of Revenue in the 1993 and 1994 tax year filing seasons, where actual Minnesota state taxpayers were issued with a normative appeal or a letter stating that their income tax returns would be "closely examined."

BEHAVIORAL ECONOMICS AND THE PURPOSES OF TAXATION

It is worth briefly discussing the purposes of taxation in order to identify the issues and also because it indicates—for example, in the discussion relating to Figure 29.1 below—how the behavioral contribution might fit into a more general economic framework. Following Musgrave (1959) and others, the economic justification for the public sector and the consequent requirement for taxation may be classified into three areas: the allocation branch, the distribution branch, and the stabilization branch. The allocation branch is concerned with inefficiencies in the market system in the allocation of economic resources. In an important sense this is the root of the economic rationality approach to tax compliance, although of course economic decisions may also be influenced by other factors. The distribution branch is concerned with the redistribution of income and wealth toward a scheme that society considers more equitable. It is in this branch that behavioral economics has a particularly important role to play. The third area is the stabilization branch, which might justify a role for government in trying to smooth out cyclical economic fluctuations and ensuring a high level of employment and price stability. There has been considerable debate and dispute about how effective the public sector can be in this matter (see, for example, James and Nobes 2003, ch. 6), but both mainstream and behavioral economics add to our understanding of such issues.

Musgrave's classification provides a useful general framework for attempting to integrate the contribution of behavioral economics to tax compliance, and this is shown graphically in Figure 29.1. The allocation branch is concerned with issues of efficiency in resource allocation, and this is conventionally analyzed by supposing that individuals act to maximize utility. Tax compliance is therefore also seen as a matter of economic rationality, with taxpayers as individuals who consider the pecuniary gains and losses from compliance or noncompliance. The distribution branch is concerned with issues of equity and incidence—how the effects of taxes are distributed. This would see taxation as an equity matter and might view the taxpayer in the more complex role of a member of society rather than simply a calculator of personal gains and losses. Both approaches offer explanations of compliance behavior and major contributions to the development of a compliance strategy.

Figure 29.1 **Different Economic Approaches to Tax Compliance**



The main question of interest is how to integrate them in designing an overall strategy by deriving what might be called an optimal compliance policy. While there is a wealth of literature on various aspects of compliance, there is relatively little on how these aspects might be optimally combined with others in order to develop an overall compliance policy. This could, however, be important even at a more detailed level. For instance, Klepper and Nagin (1989) point out that a policy innovation designed to reduce one form of noncompliance might result in taxpayers transferring their noncompliance activities to take advantage of a now superior alternative opportunity. Simply assessing only the direct impact of that measure might be inadequate and misleading. More generally, a full evaluation of any aspect of compliance policy should take account of its effects on each of the relevant areas. In order to do this it is helpful to use insights from behavioral economics to improve the definition of tax compliance.

THE BEHAVIORAL CONTRIBUTION TO THE DEFINITION OF TAX COMPLIANCE

It is clear from the study of behavioral economics that the definitions of tax compliance frequently used in the literature are too simplistic. A more comprehensive definition has been developed by James and Alley (1999). The most common previous approach has been to conceptualize compliance in terms of the "tax gap." This represents the difference between the actual revenue collected and the amount that would be collected if there were 100 percent compliance, though there are some variations. For example, and rather curiously, Brand (1996) refers to the "market share" of the Internal Revenue Service (IRS) in the United States. What Brand means by this is "the amount of the projected total tax base that the IRS actually collects." Andreoni, Erard, and Feinstein (1998) include a time dimension to compliance but are still mainly concerned with tax evasion as the central part of the tax gap definition. A more recent definition covers three distinct types of compliance: payment compliance, filing compliance, and reporting compliance—which Brown and Mazur (2003, 689) state are "three mutually exclusive and exhaustive measures."

However, such basic concepts are far too simplistic for practical policy purposes. Successful tax administration requires that taxpayers cooperate in the operation of a tax, rather than be forced to undertake every aspect of their obligations unwillingly. Tax law cannot cope with every eventuality and has to be supplemented with administrative procedures and decisions; just as important, in order to work it has to have a reasonable degree of willing compliance on the part of the taxpayers themselves.

One issue is whether "compliance" refers to voluntary or compulsory behavior. If taxpayers "comply" only because of dire threats or harassment or both, this would not appear to be full compliance, even if 100 percent of the tax was raised. Instead, it might be argued that proper compliance means that taxpayers meet their tax obligations willingly, without the need for inquiries, obtrusive investigations, reminders, or the threat or application of legal or administrative sanctions. A more appropriate definition could therefore include the degree of compliance with tax law and administration that can be achieved without the immediate threat or actual application of enforcement activity.

It is also too simplistic to suppose that there is some fixed tax revenue that would be collected if all taxpayers observed 100 percent obedience to the law. The level of potential tax revenue is determined by the level of economic activity. It is possible that an intrusive tax regime might reduce the willingness of taxpayers to earn more money or engage in commercial activity, not only because of the associated tax liability, but because that extra liability might involve inconvenient administrative requirements or the risk of a heavy-handed official response. There is also the "spite effect" described by Musgrave (1959, 240). It is not known how powerful any spite effects might be, but they could further affect the revenue potential. Paradoxically, the tax gap definition of noncompliance might then have been partly satisfied because there is less to collect.

Tax compliance may be seen in terms of tax avoidance and tax evasion. The two activities are conventionally distinguished in terms of legality, with *avoidance* referring to legal measures to reduce tax liability and *evasion* to illegal measures. Since taxation is not always precise, Seldon (1979) has also coined the term "tax avoision" to describe circumstances where the law might be unclear. However, some commentators see noncompliance only as a problem of evasion, which does not seem to capture the full policy implications of the issue. Clearly tax evasion is an extreme form of noncompliance. However, if law-abiding taxpayers go to inordinate lengths to reduce their liability, this could hardly be considered to be compliance either. Such activities might include engaging in artificial transactions to avoid tax, searching out every possible legitimate deduction, using delaying tactics and appeals wherever this might reduce the flow of tax payments, and so on. "Tax exiles" even seem to prefer to emigrate rather than fulfill their obligations as citizens—hardly an example of compliance. Even if such activities are within the letter of the law, they are clearly not within its spirit. Compliance might therefore be better defined in terms of complying with the spirit as well as the letter of the law.

The tax gap approach overlooks the possibility that some taxpayers pay more than their legal obligation. Not all taxpayers seek out every possible method of reducing their tax liability, and an unknown number do not claim their full entitlement to allowable deductions. For example, in a survey of nonfilers McCrae and Reinhart (2003) had one respondent who stated, "I pay too much tax, I'm just too lazy to claim it [a tax rebate]! But I'd rather have a decent health system and pay more."

A further complication, of course, is that taxation is used for many purposes other than simply raising revenue. As an instrument of economic and social policy, the purpose of taxation is often to influence behavior. It can therefore actually be the intention of the tax that it is avoided. For example, it has been argued that higher taxes on alcoholic drinks (Cook and Moore 1994; Irving and Sims 1993) and tobacco (Viscusi 1994) would reduce the consumption of those products and lead to improvements in the health of the population. Any such changes in behavior would constitute tax avoidance, but it would be in the spirit as well as the letter of the law and would fit the definition of compliance offered here, though not the tax gap definition. There have also been developments in other forms of "corrective taxation," referred to as environmental taxes (Smith 1992), green taxes (Oates 1995), and so on. The tax gap approach to compliance is clearly too simplistic and inappropriate with respect to compliance in such cases. Compliance in this context would appear to indicate compliance with government policy in a wider sense, rather than only compliance with the tax law, and therefore behavior that should be expected from a responsible citizen.

A definition that covers compliance with the spirit as well as the letter of the law also indicates the importance of the behavioral contribution to developing policies for promoting compliance.

APPLICATIONS OF BEHAVIORAL THEORY

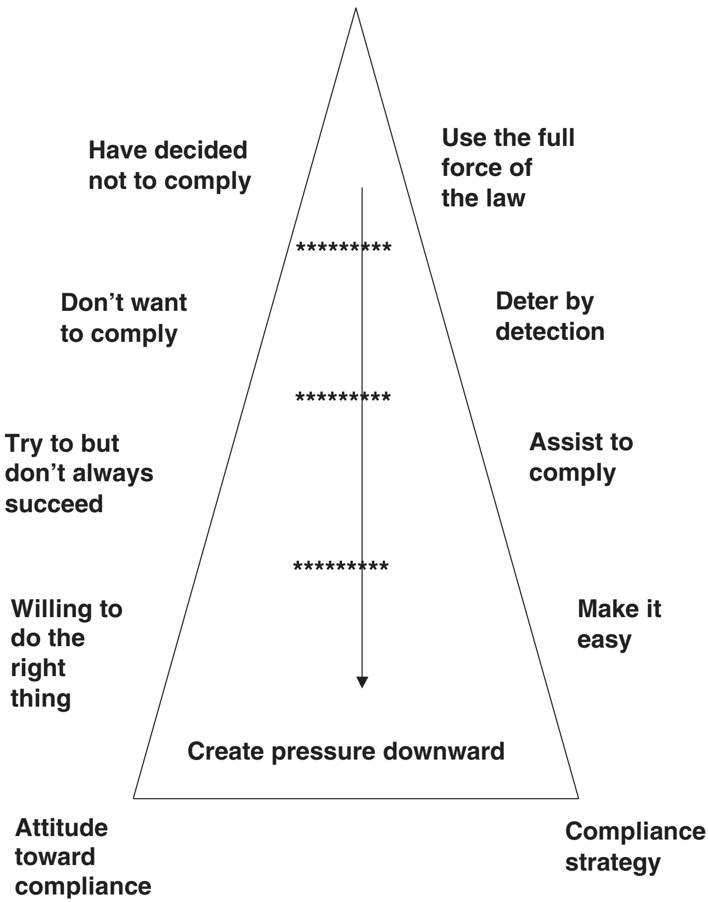
Tax authorities in many countries, such as Canada, Sweden, the United Kingdom, and the United States, have attempted to improve communication with taxpayers and to increase their awareness of the tax system and how to meet their obligations. Furthermore, they have been doing so for some time (James, Lewis, and Allison 1987). In recent years the behavioral approach and specific compliance models have been adopted more explicitly as guides to compliance strategies.

One example is the model developed by Braithwaite and Braithwaite (2001), where the style of enforcement emphasized is to begin by taking account of the problems, motivations, and conditions behind noncompliance. Taxpayers are initially given the benefit of the doubt, and the revenue service's trust in their honesty is an important part of an initial regulatory encounter. Strong emphasis is placed on educating taxpayers regarding their tax obligations and assisting them to comply, while those aspects of administration that rely principally on threats and the automatic imposition of penalties are not emphasized. It is only when taxpayers continue to be uncooperative that more interventionist measures (for example, sanctions) are considered.

The Australian Tax Office and the New Zealand Inland Revenue Department have both used such a model to develop their tax compliance strategies, and it is illustrated in Figure 29.2.

The Internal Revenue Service (IRS) in the United States has also made considerable moves in similar directions, despite its reputation at times for considerable enthusiasm in rigorously administering the tax system (for example, see Payne 1993). The new approach was endorsed by then Vice President Al Gore and Treasury Secretary Robert E. Rubin (1998) with this straightfor-

Figure 29.2 **Compliance Model Used in Australia and New Zealand**



Source: Adapted from New Zealand Inland Revenue Department 2003, 6.

ward statement: "Our philosophy is simple: the taxpayers don't work for us, we work for them." However, the IRS has been developing this approach to promoting voluntary compliance for some years, as outlined in its forward-looking document *Compliance 2000* (U.S. Internal Revenue Service 1991). The strategy described in that document included behavioral issues such as proposals for more public education and inculcating in citizens a sense of responsibility toward taxes. The shift in the IRS's emphasis from enforcement to service to taxpayers is illustrated by Plumley and Steuerle (2003). In comparing the 1984 and 1998 IRS mission statements, they noted a change from "the purpose of the IRS is to collect the proper amount of tax *revenue* at the least cost to the public" (1984) to "provide America's taxpayers top quality *service*" (1998).

FUTURE RESEARCH

Behavioral economics is concerned with a wide range of factors—cultural, institutional, psychological, and social—that influence human decision making. Such factors vary over time, as does the tax system, and so future research seems to be limitless. Furthermore, the work on tax compliance could be extended to cover economic decisions in relation to compliance with many other obligations of one sort or another.

In terms of taxation, a particular line of future research relates to the development of e-commerce (Hickey 2000) and, indeed, e-taxation. Another is that most of the work so far is related to individual behavior, but there is also considerable scope to develop research relating to business behavior. In all areas there will be work for those with skills in compliance. As Edmund Burke (1780) put it: “Taxing is an easy business. Any projector can contrive new compositions; any bungler can add to the old.”

CONCLUSION

There is no doubt that neoclassical economic analysis provides a great deal of insight into economic behavior. However, it is also clear that a wider behavioral approach can add considerably more to our understanding of economic activity. Individuals often do act in their own self-interest narrowly defined, but their behavior is also influenced by much wider considerations regarding their interactions with other individuals and society as a whole. Factors such as social norms, morals, perceptions of justice, various attitudes, and particular beliefs can influence the way people behave, even sometimes if their behavior is not in their own immediate self-interest. In the present context, behavioral economics adds enormously to our understanding of taxpayer behavior with respect to tax compliance—indeed, even in the development of a more comprehensive and appropriate definition of tax compliance itself. It has also enabled revenue services to develop a more sophisticated and appropriate strategy for promoting tax compliance.

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