Understanding and Combatting Tax Evasion

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UNDERSTANDING AND COMBATTING TAX EVASION

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Although it is often said that the only things certain in life are death and taxes, taxes at least are far from inevitable, and individuals take a variety of actions to reduce their tax liabilities. Some are legal “tax avoidance” activities, such as income splitting, postponement of taxes, and tax arbitrage across income that faces different tax treatment. “Tax evasion” refers to illegal and intentional actions taken by individuals to reduce their legally due tax obligations, by underreporting incomes, by overstating deductions, exemptions, or credits, by failing to file appropriate tax returns, or even by engaging in barter. Generating estimates of the magnitude of tax evasion is difficult, but there is consistent, if somewhat imprecise, evidence that these many avenues for tax evasion are common in most all countries.

The contribution by Ignacio Mauleón demonstrates the widespread presence of tax evasion in Spain, as proxied by the “underground economy”. My own estimates for Spain are smaller, but still indicate a large underground sector at about 1/6 of GDP in recent years.

An essential issue that all countries, including Spain, must therefore face is finding ways to combat tax evasion. Doing this first requires an understanding of what motivates tax evasion, and then using this understanding to devise appropriate policies.

My own reading of the vast and expanding literature on what motivates behavior indicates that individuals respond predictably, if not always significantly, to such factors as higher tax rates, increased audit rates, more “productive” audits, repeated audits, strategic/targeted audit selection, public disclosure of audit, public dissemination of audit information, increased penalty rates, greater use of source-withholding, more use of information-sharing between government audit agencies, greater rewards – public or private – for compliance, a closer taxes-services linkage, increased taxpayer participation in group decisions, tax amnesties, increased complexity and uncertainty, and better taxpayer services. In short, individuals are influenced by narrowly defined, and individually based, financial considerations and by the ways in which they process this information; they are influenced by social considerations (e.g., a “social norm”); and they cannot be represented by a single representative agent, but must be considered a collection of different segments.

These results may be expected. However, this research also suggests a number of other results.

First, audits clearly affect compliance, but with some important qualifications. For example, audits increase compliance but in a non-linear way, so that the deterrent effect diminishes with higher audit rates. There is also a “spillover effect” from audits to individuals who are not themselves audited, and this spillover effect is significantly larger than their direct deterrent effect. Also, strategic audit selection (especially a “cutoff rule”) is far better than random
selection, but some random selection seems necessary for strategic audits to work.

Second, perceptions of audit rates affect compliance. Indeed, individuals appear to substantially misperceive audit rates, typically overweighting a (low) probability of audit; that is, “psychology” – and other behavioral economics factors – clearly matters.

Third, fines also affect compliance, but the deterrent effect of fines is quite small, and audits have a significantly greater deterrent effect.

Fourth, positive rewards improve compliance, whether individual (e.g., lotteries, social insurance benefits) or aggregate (e.g., public goods). Indeed, the “carrot” of rewards is often more effective in encouraging compliance than the “stick” of enforcement.

Fifth, tax rates affect compliance but in ways that go beyond their simple incentive effects. The level of tax rates matters in an individual’s compliance decision, although the magnitudes – and even the directions – of impact are unclear. One’s tax rate relative to others’ (e.g., “fiscal inequity”) is a crucial factor. The use of taxes also affects compliance, especially when individuals can choose the use.

Sixth, this last factor suggests that process (versus outcome) affects compliance. Indeed, there seems to be a “social norm” of compliance, and this social norm can be affected by the institutions that face individuals, by individuals’ attitudes toward these institutions, and by individual participation in the selection of those institutions.

Seventh, the information that individuals have about the tax system and other individuals affects compliance. For example, higher audit rates have no impact on compliance if this “official” information is not provided; if it is provided, higher audit rates increase compliance. Similarly, knowing what your neighbors are doing affects your own decisions, and not always in a way that increases compliance. Indeed, information per se does not always improve compliance. In this regard, knowing how your tax dollars are spent often has a positive, if small, impact on compliance. Also, group heterogeneity seems to affect compliance through “social capital”, with greater heterogeneity (e.g., race, religion) often reducing tax compliance.

Eighth, tax amnesties affect compliance (possibly through their effects on social norms), but amnesty effects seem neither large nor small, neither all that positive nor all that negative. More generally, institutions matter.

Ninth, a complicated tax system affects compliance, but the impact is far from clear. Field data suggest that an increase in complexity leads to greater use of a “tax practitioner” – and compliance is lower for returns prepared by a practitioner. Laboratory experiments suggest that a more complicated tax system tends to decrease compliance and also that better administrative services that make it easier for an individual to pay taxes tend to improve compliance. However, these effects are weak, and more work is needed here.
Tenth and finally, there is no “typical” individual who responds predictably and reliably to all policies. People are complicated, motivated by many different factors, responsive (if at all) in different ways. There is considerable evidence that individuals are motivated by many factors beyond narrow financial interest. For example, laboratory and field experiments have shown that individuals who have greater sympathy (as measured by the frequency of pro-social behavior) are more compliant, that individuals who are “primed” to elicit empathy or to do the “right” thing are more compliant. However, it is not known whether these effects are simply transitory or whether they persist. Regardless, all of this evidence suggests that there is no one single policy that will work for all people at all times, or even for the same individual at different times; that is, there is a “full house” of behaviors motivated by a “full house” of motivations.

So what does all of this evidence suggest about government policies to combat tax evasion? My own reading is that a government compliance strategy based only on detection and punishment may well be a necessary and reasonable starting point but not a good ending point. Instead, what is needed is a multi-faceted approach that emphasizes enforcement, but that also emphasizes a range of additional policies consistent with this evidence.

Now tax administration typically emphasizes a variety standard enforcement policies that seek to detect and penalize noncompliance. These policies are consistent with a paradigm that views the taxpayer as a potential criminal who must be deterred from cheating, and are clearly aligned with the economics-of-crime perspective.

However, it is increasingly the case that administrative policies are not limited to these standard enforcement mechanisms. Instead, tax administrations in many countries are introducing policies that emphasize such things as developing taxpayer services to assist taxpayers in filing returns and paying taxes, broadcasting advertisements that link taxes with government services, simplifying taxes and the payment of taxes, and even promoting a taxpayer – and a tax administrator – “code of ethics”. Put differently, the taxpayer is no longer seen simply as a potential criminal but as a potential client. There is also an emerging view that sees the taxpayer as a member of a larger group, as a “social animal” whose behavior depends upon his or her own moral values (and those of others) and also upon his or her perception of the quality, credibility, and reliability of the tax administration. These new policies suggest several additional paradigms for tax compliance.

So, I believe that there are three “paradigms” for tax administration, each with different policies.

Under the first paradigm – the traditional “enforcement paradigm” – the emphasis is exclusively on repression of illegal behavior through frequent audits and stiff penalties. This has been the conventional paradigm of tax administrations throughout history, and it fits well the standard economics-of-crime approach to tax evasion.

A second paradigm recognizes the role of enforcement, but also recognizes the role of tax
administration as a facilitator and a provider of services to taxpayer-citizens. This new “service paradigm” for tax administration fits squarely with the perspective that emphasizes the role of government-provided services as considerations in tax compliance. Indeed, many recent administrative reforms around the world have embraced this new paradigm with great success.

A third paradigm is also suggested by this work, especially the work that demonstrates the social aspects of behavior. I term this a “trust paradigm”, and it is consistent with the role of morality, of social norms, and of other behavioral economics factors in the compliance decision. It is based on the notion that individuals are more likely to respond either to enforcement or to services if they believe that the government generally and the tax administration specifically are honest; that is, “trust” in the authorities can have a positive impact on compliance.

Consequently, designing strategies to control tax evasion fall into three main categories, each consistent with one of the three paradigms: increase the likelihood and the threat of punishment, improve the provision of tax services, and change the tax culture.

First, there is scope for an improvement in policies to increase detection and punishment (e.g., the “enforcement paradigm”). These policies includes such obvious actions as increasing the number of audits, improving the quality of the audits (and of the auditors), using more systematic audit selection methods (e.g., “scoring” methods), improving information-sharing across governments, increasing penalties for tax cheating, publicizing tax evasion convictions in the media as an alternative non-financial type of penalty, applying penalties often and consistently, relying more heavily on source-withholding, granting additional power for collecting delinquent accounts, and increasing taxpayer registration and identification via better use of third-party information.

Second, there is scope for an improvement in the services of the tax administration by becoming more “consumer-friendly”, along the lines of the “service paradigm”. Such policies include promoting taxpayer education, providing taxpayer services to assist taxpayers in filing returns and paying taxes, improving phone advice service, improving the tax agency website, simplifying taxes and tax forms, and simplifying the payment of taxes.

Third, there is scope for a government-induced change in the culture of paying taxes, consistent with the “trust paradigm”, by using the mass media to reinforce tax compliance as the ethical form of behavior, publicizing cheaters, emphasizing the link between payment of taxes and the receipt of government services, targeting certain groups (e.g., new firms or employees) in order to introduce from the start the notion that paying taxes is “the right thing to do”, enlisting other organizations to promote compliance, avoiding actions that lead individuals to think cheating is acceptable (e.g., a tax amnesty), and addressing perceived inequities in the ways people feel that they are treated. It is this third paradigm that is, I believe, an essential but largely neglected strategy for improving compliance.

In short, there should be a “full house” of strategies to address the “full house” of motivations.