

## Review of Models/Theories Explaining Tax Compliance Behavior

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### Abstract

This study offers an overview of the theoretical foundations for explaining tax compliance behavior. The interest generated by the subject matter of tax compliance behavior has led to identification of several factors that are believed to influence individual tax compliance decision. These factors have been compressed into several models/theories providing insights into the subject matter. This study reviewed five prominent theories/models that have been used to explain compliance via- economic deterrence; socio-psychology; fiscal exchange; comparative treatment; and political legitimacy. The study noted that there is no 'one model fits all' for explaining tax compliance behavior, and further concludes that individual tax compliance is influenced by both economic and non-economic factors. As such, tax administrators as well as researchers on the subject matter should combine relevant models and incorporate these factors into developing effective tax systems.

*Keywords:* Tax; taxation; compliance behavior; models

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### 1.0 INTRODUCTION

Considerable amount of interests have been shown in studying peoples' reaction to taxes, especially in the fields of public finance, law and economics. It is also apparent that discussions about tax and taxation are incomplete without a mention of some form of tax reduction behavior. It is generally believed that peoples' attempt at dodging taxes have always existed with its attendant economic consequences (Fjeldstad, Schulz-Herzenberg and Sjursen, 2012). Webber and Wildavsky (1986) cited in Slemrod (2007) reported that as far back as the third century, many wealthy Romans engaged in such acts as burying their stocks of gold coins and jewelry in order to evade taxes, while homeowners in England around the eighteenth century temporarily bricked up their fireplaces as a means of escaping the notice of the hearth tax collector. Tanzi (2000) also mentioned Plato's writings about two thousand, five hundred years ago, when some people informed the Roman republic about tax evaders via a hole on the Ducal Palace in Venice.

Modern attempts at studying taxpayer compliance have however been largely credited to the works of Allingham and Sandmo (1972), which uses the economics of crime approach earlier developed by Becker (1968). The over three decades that followed have seen a sort 'explosion' in studies related to taxpayer compliance and behavior, using theoretical, empirical and experimental approaches. This has led to a body of knowledge known as tax compliance behavior, which centers on understanding the factors influencing tax compliance (or non-compliance), and the possible methods of improving taxpayer compliance, and by implication, revenue for government developmental activities.

The over three decades of extensive research into tax compliance behavior have incorporated varied disciplines, but without a consensus on the general factors affecting compliance behavior (McKerchar and Evans, 2009). The tax compliance literature has over the years indicated that so many factors – including economic, socio-psychological and demographic – usually come into play in determining individual compliance decision (Devos, 2012). Besides, individual compliance behavior also differs from one country to another and from one individual to the other (Kirchler, 2007). The resultant effect is that, today, there exists a 'cobweb' of factors that are considered as affecting taxpayer behavior, and the decision of whether or not to pay taxes.

### 2.0 TAX COMPLIANCE FACTORS

A review of the extant literature on tax compliance has so far shown that individuals' compliance decision is usually influenced by a multitude of factors. As far back as 1978, the IRS listed as many as 64 factors that are believed to affect taxpayers reporting decisions (Alm, 1999), and it has continued to increase. Obviously, there are few (if any) model that can accommodate as much factors, (along with their respective drivers) at the same time. As such, the common practice, as "logic suggests is to concentrate on the factors that appear to have the most impact on compliance levels" (Devos, 2012:181), and that are considered important to the specific context or situation at hand. So far, the literature has indicated that factors affecting taxpayer compliance are often discussed under groupings of between 2–5 theories/models, which are sometimes also referred to as 'schools of thoughts' (see McKerchar and Evans, 2009; Devos, 2012; Fjeldstad, *et al.*, 2012). This paper adopts the 5 groups of factors by Fjeldstad, *et al.* (2012) and Ali, *et al.* (2013). The five groupings of factors,

which are mostly adapted from research by the OECD Forum of Tax Administration (OECD, 2010) are: *Deterrence; Social Psychology, Fiscal Exchange, Comparative Treatment, Political Legitimacy and Trust in Government*.

### 2.1 The (Economic) Deterrent Model

This model assumes that behavior is influenced by factors such as, tax rate (which determine the benefit of tax evasion) and penalties for fraud and probability of detection (which determine costs). The economic deterrence model in its basic form views the individual taxpayer as a rational economic agent, who assesses the costs (determined by probability of detection and penalties for fraud) and benefits (determined by tax rate) of evading taxes, and thus chooses not to pay, if the benefit of non-compliance outweighs the costs (Walsh, 2012). The model thus reduces the problem to that “...of rational decision making under uncertainty whereby tax evasion either pays off in terms of lower taxes or subjects one to sanctions” (Fjeldstad, Schulz-Herzenberg and Sjursen, 2012:3). The implication of this assumption is that when there are low audit probabilities and low penalties, the tendency for evasion will be higher, while if there is a high tendency for detection and penalties are severe, fewer people will evade taxes (Fjeldstad, Schulz-Herzenberg and Sjursen, 2012). It is on the basis of this assumption that the model advocates stricter audit and heavy penalties for offenders as a basis for reducing non-compliance.

The economic deterrence model has over the years, undergone series of modifications and extensions, and still enjoys prominence in most studies on taxpayer compliance. However, it has also been criticized as not being realistic in explaining taxpayer compliance, since it predicts a general substantial noncompliance beyond what is obtainable in reality (Slemrod, 2007). Rethi (2012) and Slemrod, (2007) observed that in spite of the existence and use of audits and penalties (which are the key components of the deterrence model), tax evasion has remained, and continuously posed significant threats to countries’ economies, through loss of revenue. Besides, it has also been observed (even proven in studies) that there are people who never evade taxes, even when the probability of detection is zero (Sour, 2004). A classic example is in the case of the United States and Scandinavia, where empirical data revealed high level of compliance “...more than what could be accounted for even by the highest feasible levels of auditing, penalties and risk aversion” (Fjeldstad, Schulz-Herzenberg and Sjursen, 2012: 3). This reality has in fact led a number of authors to comment that going by the deterrence model, the actual question regarding tax compliance should be why people pay taxes, and not why people evade them (Alm, 1999; Alm *et al.*, 1992; Slemrod, 1992).

Aside from the limitations noted above, the deterrence model has also faced criticism for failing to consider behavioral factors such as attitudes, perceptions, and moral judgments (Lewis, 1982); for neglecting the presence of codes of conducts, such as moral and ethical constraints that have potentials to prevent people from cheating in their taxes (Sour, 2004); and for neglecting the relevance that tax compliance takes place in a social context (Rethi, 2012). The aggregation of the above criticisms have thus led to the incorporation of diverse perspectives/fields –especially behavioral- into the study of tax compliance behavior, and subsequently, development of broad-based factors that affect taxpayers’ (non)compliance behavior.

### 2.2 Social-psychology Models

A common proposition of the theory of reasoned action is that individuals form their behavioral intentions on the bases of two basic determinants – personal factors and social influences (McKerchar and Evans, 2009). These are commonly referred to as personal norms and social norms respectively, and have become the focus of studies based on social psychology theories explaining taxpayer behavior. They are generally noted to play important roles in determining tax compliance (Franzoni, 1999; Sour, 2004; OECD, 2010), just as Ronan and Ramalefane (2007) specifically noted that such variables as stigma, reputation and social norms have great impact on taxpayers’ decision on whether or not to comply with tax payments.

Personal norms have been defined as the deeply rooted convictions about what one ought or ought not to do (OECD, 2010). They are –in most cases- difficult to change and often beyond the reach of public policy” (Franzoni, 1999), because they take a long time of socialization processes to be developed (OECD, 2010). In the context of taxpayer behavior, personal norms reflect the taxpayers’ values, tax ethics, tax mentality, and tax morale, all of which influences attitudes towards taxes/compliance. Sour (2004) contended that engagement in acts of evasion may induce feelings of anxiety, guilt or negative self-image in taxpayers. A contention that is in line with the findings of Taylor (2001), who observed that the (internal) fear of experiencing feelings of guilt, along with the risk of social stigmatization have greater deterrent effect than such external factors as the risk of detection and punishment.

The fear of social stigmatization as a possible deterrent factor is a confirmation of the belief that tax compliance takes place within a social context (OECD, 2010; Kirchler, 2007), and the existence of the social norms effect on compliance behavior. Social norm, according to Alm (1999: 9) is “... a pattern of behavior that is judged in a similar way by others and that therefore is sustained in part by social approval or disapproval”. This affects tax compliance since it is common for people to discuss their tax affairs with friends, family members, and at their jobs (Sour, 2004). It therefore follows that an individual is most likely to comply with tax requirements if he believes members of his reference groups also comply, just as he is also likely not to comply if he believes that members of his referent group do not comply (Lewis, 1982; Franzoni, 1999; OECD, 2010; Fjeldstad, *et al.*, 2012; Walsh, 2012; Ali, *et al.*, 2013).

### 2.3 Fiscal Exchange

The fiscal exchange theory is acclaimed to have evolved from the economic deterrence and the social psychology models (McKerchar and Evans, 2009), and is premised upon the existence of a social, relational or psychological contract between the government and the taxpayers (Frey and Feld, 2002; Torgler, 2003; Fjeldstad, *et al.*, 2012). The model thus suggests that the presence of government expenditures may serve as a motivating factor for taxpayer compliance, especially when the taxpayers value the goods and services they perceive to be receiving from the government (Alm, McClelland and Schulze, 1992; Alm, 1999; Fjeldstad, *et al.*, 2012). It is on this basis that Fjeldstad, *et al.* (2012:4) opined that the taxpayer may be seen as exchanging their “...purchasing power in the market in return for government services”, with the exchange being largely conditional, and varying as the government vary in its performance. Thus, the taxpayers will be more willing to comply when they are satisfied with the provision of services from the government, even in the absence of detection and punishment (Torgler, 2003). Conversely, they are also likely to adjust their terms of trade, by reducing compliance when

they are dissatisfied with services provision from the government, or even when they dislike the way their taxes are spent (Spicer and Lundtstedt, 1976; Smith, 1992; Alm, 1999; Palil, 2010).

Another major proposition of the fiscal exchange theory is that of tax bargaining between taxpayers and the government, which is considered as central to building relations of accountability, mutual rights and obligations between state and society (Fjeldstad, *et al.*, 2012). Alm (1999), citing several works, also noted that evidences exists from empirical, experimental, and simulation researches, that points to the fact that compliance is affected by collective decision process. This is especially so in democratic countries, where the taxpayers are presumed to be in a position to renegotiate their tax contract with the government, since they can monitor and control politicians, and partake as rule setters (in tax matters) via referenda and initiatives respectively (Torgler, 2003b). This probably accounts for the assertion by Engen and Skinner (1996:617), that in America "...a presidential campaign is incomplete without at least one proposal for tax reform."

## 2.4 Comparative Treatment

It is a common believe that people comply with the law if they perceive the process leading to the law as generally fair (Tyler, 1990; McKerchar and Evans, 2009). This is the main focus of the comparative treatment model, which is essentially based on the equity theory (Ali, *et al.*, 2013). It thus proposes that individuals are more likely to exhibit higher tax compliance when they perceive the entire tax system as fair, and vice versa (Sour, 2004; GIZ, 2010; OECD, 2010). The influence of perceived fairness of the tax system on compliance decision is not limited to the treatment of the individual taxpayer only, but also relates to the tax burdens of other individuals, as well as their observed compliance behavior (Sour 2004; Walsh, 2012). Compliance rate is noted to increase when an individual perceives his tax burdens to be "...of about the same magnitude as that of comparable others ...". (Feld and Frey, 2006:15), just as evasion is observed to have increased when people become aware that their tax burdens are greater than those of others in the same group (Spicer and Becker, 1980).

Situations could also arise, when individuals are subjected to higher tax burdens, as against lower corporate profit taxes, which may make the individual taxpayers to perceive an unfair tax burden, and thus chose to declare only a part of their income as a means of getting even with the tax system (GIZ, 2010). The perceived fairness of a tax system also increases when individuals believe that other people around also pay their taxes, and this improves their willingness to comply (Sour, 2004). Conversely, when taxpayers perceive that tax evasion is prevalent in the community, the act gradually becomes the norm, and subsequently decreases their intrinsic motivation to contribute to the society (Torgler and Schneider 2005).

Three types (levels) of fairness in taxation have been discussed by OECD (2010): *distributive* fairness, which relates to the taxpayers' perception that the government acts as good custodian and wise spender of tax revenues; *procedural* fairness, which relates to the perception that tax bodies adhere strictly to established procedures, and are fair in dealing with taxpayers; and *retributive* fairness, which relates to the perceptions that tax authorities are fair in the application of punishments when the tax rules or norms are violated. While distributive fairness deals more with exchange equity between the government and taxpayers, and can thus be linked with fiscal exchange theory, procedural and retributive fairness are more relevant to the issues of comparative treatment, and can be influenced by tax administrations (Walsh, 2012), by emphasizing fairness and transparency in handling of tax matters.

The importance of equity and fairness in taxation is that it does not really matter if the outcome favors the individual taxpayer or not. Most taxpayers may still perceive a tax authority as fair and just, even if it acted against them, but in a good manner. This naturally results in fewer complaints about the authority's decision (OECD, 2010). Equity and fairness in tax matters also builds mutual trust and cooperation between tax bodies and the taxpayers, which subsequently enhances voluntary compliance (Kirchler and Hoelzl, 2006; Braithwaite, 2008; GIZ, 2010).

## 2.5 Political Legitimacy and Trust in Government

One model explaining determinants of tax compliance, -perhaps with emphasis on Africa- is that of political legitimacy, which Fjeldstad, *et al.* (2012:7) and (Ali, *et al.*, 2013:5) define as the "...belief or trust in the authorities, institutions, and social arrangements to be appropriate, just and work for the common good." It is normal to expect that the more citizens trust their government and social institutions, the more likely they will voluntarily abide by the decisions and rules set by such government and institutions, and this influences tax compliance decisions (Tyler, 1990, OECD, 2010). Evidence to such situations where the government is perceived to work for the common good is found in the works Picur and Riahi-Belkaoui (2006) who, based on a study of 30 developed and developing countries, found that tax compliance is highest in countries with high control of corruption and low size of bureaucracy. Richardson (2008) thus suggests the need for governments to increase their reputation and credibility, as a means of gaining the taxpayers' trust.

Closely linked with political legitimacy are the issues of national pride, and political affiliations. Tyler (2000) contended that national pride influences peoples' behavior in groups and provides a basis for encouraging cooperation, just as it positively impacts tax morale (Torgler and Schneider 2005; McKerchar and Evan, 2009). Palil (2010) noted that identification with the ruling government party and its policies also influences tax compliance. He contended that "...if an individual favors the current ruling government party, he might choose to be compliant because he believes that the government is trusted, efficient and equitable", while if he is in favor of the opposition, he "...might be more noncompliant because he perceives that the government is not on his side" (p.204).

## ■ 3.0 CONCLUSION

Issues bothering on taxation are of great importance to the people and government of any society. This fact has been confirmed by the reviewed literature, and it thus justifies the considerable interests given to the subject of tax compliance by governments, tax authorities and academics. The review of literature has shown that it is almost impossible to have 'one universal' model for studying compliance behavior, as several factors usually influence individuals' decision to comply (or not) with tax payments. These factors typically differ from country to country and from one situation to another. The available models for studying tax compliance have (individually and

collectively) provided insights into understanding taxpayer compliance, as such, tax compliance researchers can make a choice or a combination of models that best suits their environment and situations facing them.

A major conclusion that can be drawn from all the models of tax compliance is that compliance (or non-compliance) is influenced by both economic and non-economic factors. It is therefore pertinent that tax administrators and academics pay more attention into developing effective tax systems that will consider the possible combination of the economic and non-economic factors that individuals consider when making their compliance decisions.

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