

PSYCHOLOGY OF TAX COMPLIANCE AND ITS IMPACT ON TAX REVENUE GENERATION: A THEORETICAL APPROACH

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ABSTRACT

In this study, tax compliance psychology is examined from a theoretical perspective and its impact on tax revenue generation. While the traditional economics models of tax compliance focus primarily on deterrence, the probability of audit, the amount of penalty, and the fear of punishment, these factors are just a few of the reasons why taxpayers might not comply with the tax law. But this is not a complete answer as to why, despite limited penalties and low audit rates, many citizens still pay taxes. The study, therefore, draws on the theory of behavioral economics, social psychology and institutional theory. It emphasizes central psychological variables like tax morale, trust in authorities, perceived fairness, social norms and psychological contract of citizens and the state. The study also uses the Slippery Slope Framework that emphasizes the importance of both authority power and public trust in determining enforced and voluntary compliance. Strict enforcement, it is found in the theory, can lead to an increase in tax revenues in the short term but the sustainable tax revenues are more dependent on voluntary compliance which can be obtained through trust, fairness, transparency and positive attitudes of taxpayers. This study ends up establishing that the process of tax revenue generation is not only an economic or legal issue but is a psychological and social process as well. Hence, governments should go beyond the excessive burden on penalties and audits and establish a fair, transparent and trust-based tax regimes, which would invite citizens to pay tax without due compulsion.

KEYWORDS: Tax compliance, tax morale, tax revenue generation, voluntary compliance, trust in authorities, perceived fairness, behavioral economics.

1. INTRODUCTION

Tax revenue is the most important contributor to sustainable economic development, infrastructure development and public welfare of any country. Economic history shows exactly how much states lack basic services for their citizens without a stable tax system, particularly health, education and security. The traditional economic theories are listed, with the (Allingham & Sandmo, 1972) model at the top. Compliance with taxes has always been thought to be a purely economic and rational decision. From the traditional standpoint, the taxpayer's choice between paying taxes and evading them depends on his fear of punishment, the magnitude of the penalty and the risk of audit. With the recent decades, however, behavioral economists and psychologists have thrown challenges of a fundamental nature to this traditional viewpoint. Tax evasion would be far more prevalent today in many countries of the world than it is by today, if nothing more hazardous than economic punishment were not available to collect taxes. In economics, this is referred to as "The Tax Compliance Puzzle. The answer to this puzzle is that the choice of paying tax or not is not only related to the pocket (economics), but it's also related to the mind and behavior (psychology). Taxpayers' psychology, values, and trust in the state are among the factors which have direct and profound impacts on the generation of tax revenues. Recent studies have provided some significant theories to account for tax compliance psychology. Of these, the most well-known is the "Slippery Slope Framework". In this framework, tax compliance is

dependent on two pillars – one being the “Power of Authorities”. The second one is “Trust in Authorities”. Fear can be instilled in the citizens when there is forced collection of taxes (Enforced Compliance). However, new loopholes to evade tax open up in the long run. In contrast, in states that have good relations with the people, the trust between state and people is strong. They have voluntary compliance with tax payments there (Voluntary Compliance). This voluntary compliance, not only lowers the cost of collecting taxes, but also consistently results in increased tax revenues. Tax Morale (internal moral impulse to pay taxes), Social Norms (the general attitude of society) and Perceived Fairness are among these psychological factors and play a fundamental role. When citizens think that the tax system is fair. It is applicable to all, whether rich or poor, and their funds are being spent for the public good, rather than for corruption. Thus they tend towards a positive compliance psychology. On the other hand, when injustice and mistrust prevail in the system, tax evasion is nothing more than a psychological barrier. Which is the big one that has a significant impact on the overall tax revenue of the country. The existing literature mainly discusses micro and macro-economic aspects of tax revenues. While psychological and behavioral aspects are often put on the back burner or they are limited to just a few empirical surveys. In an attempt to fill this gap in research this paper is offered. The main objective of this research is to develop a comprehensive and coherent theoretical framework for the relationship between the psychology of tax compliance and tax revenue generation. The main objective of this research is to develop a comprehensive and coherent theoretical framework for the relationship between the psychology of tax compliance and tax revenue generation. We will compare different economic and psychological theories to illustrate how the tax net can be widened by changing human behavior. This paper will not only add to the literature on behavioral economics at the academic level, but will also prove to be an important guide for policy makers. This research will help conclude that relying solely on penalties and fines is not enough to increase tax revenue. Rather, it is imperative to restore a favorable psychological environment and state trust that can encourage citizens to pay taxes willingly.

2. LITERATURE REVIEW

The relationship between tax compliance and state income or tax revenue generation is a long-standing topic in economics and public finance. Traditionally, only material and economic motivations have been given importance in this field. But in the past few decades, the convergence of behavioral economics, social psychology, and institutional economics has created a new intellectual angle. This literature review covers all the schools of thought that have explained the psychological and economic factors that influence taxpayer behavior.

2.1 The Economic Deterrence Paradigm

Formal scientific studies of tax compliance begin with the famous model of Allingham and (Sandmo, 1972). Which is based primarily on Gary Becker's (Becker, 1968) Economics of Crime. This school of thought is called "Economic Deterrence Theory". This model is based on the assumption that the taxpayer is a highly selfish, rational, and profit-and-loss calculating agent (Rational Economic Agent). In economics, this is called Homo Economicus. According to Allingham and Sandmo, an individual considers the following mathematical factors when deciding whether to evade taxes:

- a) Tax Rate (t): What is the current tax rate and how much money can be saved by evading it?
- b) Audit Probability (p): What are the chances that its accounts will be audited by tax authorities?
- c) Penalty Rate (f): If caught stealing, how much of a financial fine or punishment will have to be paid according to the law.

Under this traditional model, tax compliance can only be increased. When the audit rate (p) and the severity of fines (f) are increased to the point that the expected utility of tax evasion becomes zero.

2.2 The Failure of the Economic Model and the "Tax Compliance Puzzle"

Although Allingham and Sandmo's model was mathematically very appealing, it failed when the researchers applied it to real-world data. Prominent economists such as James (Alm, 2012) and (Bruno Frey, 1997) have analyzed public data to prove that in most countries around the world, audit rates are less than 1 percent and the penalties are not severe enough to scare people. If people made decisions solely based on profit, loss, and fear of punishment, tax evasion rates would exceed 90 percent in every country in the world. But the reality was the opposite; millions of citizens regularly pay their taxes without fear of harsh audits or punishment. This paradox has been called "The Tax Compliance Puzzle" in the economics literature. This puzzle proved that fear of punishment is not the only means of changing human behavior. There are hidden factors beyond tax morale and intrinsic motivation that compel it to comply with the law.

2.3 Tax Morale and Intrinsic Motivation

To solve the "tax compliance puzzle", the concept of "Tax Morale" (the internal moral impulse to pay taxes) was introduced in the literature. (Torgler, B. 2007) presented tax morale as a core variable in several of his studies. Which refers to the inner, moral, and social yearning of any citizen that makes him realize that paying taxes is his national and moral duty. According to (Feld, L. et al. 2006), understanding tax morale requires studying two fundamental aspects of psychology:

2.3.1 Intrinsic vs. Extrinsic Motivation

Citing (Deci, E. L., & Ryan, R. M. 1985) "Self-Determination Theory", (Frey, B. S. 1997) argued that human behavior is subject to two types of motivations. When governments only emphasize punishments and fines (Extrinsic Motivation), it kills the intrinsic moral impulse of citizens (Intrinsic Motivation). This phenomenon is called the "Crowding-Out Effect" in the literature. That is, by being too strict, people stop paying taxes voluntarily and the system shifts completely to coercion. That is, by being too strict, people stop paying taxes voluntarily and the system shifts completely to coercion.

2.3.2 Social Norms and Peer Effects

(Wenzel, M. 2004) made it clear in his research that taxpayers do not make decisions in isolation, but rather they look at their society. If it becomes a "social norm" in a society that tax evasion is a matter of cunning and pride, then the tax morale of even good citizens declines. Conversely, if tax evasion is considered a social evil and causes social stigma in society, then people pay taxes honestly to avoid psychological guilt.

2.4 The Slippery Slope Framework

The most comprehensive and modern model in the taxonomy and psychology literature was presented by (Kirchler, E., Hoelzl, E., & Wahl, I. 2008). It is called the "Slippery Slope Framework." The specialty of this framework is that it combines the traditional economic model (Deterrence) and the psychological model (Tax Morale) into a dynamic graphical framework. According to Kirchler and his colleagues, any country's tax revenue revolves around two basic pillars:

2.4.1 Power of Authorities

This refers to the ability of tax agencies (such as the FBR or IRS) to catch and punish tax evaders. According to the literature, when the power of authorities is high, "Enforced Compliance" arises in society. People pay taxes out of fear of the law, but they always consider the government their enemy and try to get out of the tax net whenever they get the chance.

2.4.2 Trust in Authorities

This refers to how much confidence the public has in the government's intentions, honesty, and transparency of the tax system. Literature proves that as public trust in the state increases. The graph of "Voluntary Compliance" in society is rapidly rising. In the case of voluntary compliance, administrative costs of tax collection become negligible and the tax base is expanded on a permanent basis. This framework by Kirchler concludes that "power" alone is not enough for sustainable tax revenue. Rather, only a perfect balance of power and "trust" (Dynamic Equilibrium) can make a country's tax system stable.

2.5 Perceived Fairness and the Psychological Contract

In the modern behavioral public finance literature, the relationship between the state and citizens has been viewed as an unwritten "psychological contract" (Feld, L. P., & Frey, B. S. 2007). The spirit of this agreement is that citizens will pay taxes to the state and in return, the state will provide them with security and basic rights. If the state does not fulfill its promise, citizens also begin to psychologically consider themselves justified in tax evasion. The fascist agreement depends on "Perceived Fairness", which has been divided into three dimensions in the literature (Spicer & Lundstedt, 1976; Alm et al., 2010):

2.5.1 Distributive Justice

The taxpayer psychologically compares how much money he is giving to the government and what he is getting in return in the form of public goods (health, education, roads). If citizens feel that their hard-earned money is being wasted on the luxuries or corruption of the ruling class instead of public services. Their enthusiasm for paying taxes is immediately lost.

2.5.2 Procedural Justice

This is linked to the complexity of the tax laws and behaviour of tax officials. When it's a tedious, confusing and embarrassing tax filing process. People won't be put into the tax net. A clear and respectful tax regime on the other hand, enhances compliance.

2.5.3 Retributive Justice

Citizens listen to the accountability of powerful and rich individuals that avoid paying taxes. If it is only a matter of imposing pressure on the poor/working classes and exempting the big guys. If the legit judgement of the whole system is destroyed. The impacts of which are seen as a loss of taxes.

2.6 Literature Summary and Research Gap.

The process of tax compliance is not an easy process of economics, as can be concluded from the in-depth reading of the published materials. It's a complex blend of human activities, psychological interactions and institutional confidence.

2.6.1 Research Gap

There is much literature yet to be explored within the literature of tax moral, slippery slope and fairness studies, but the potential new tax effect has not been discussed.

a) Inadequate Mathematical Modeling

Existing data is scattered and a model that combines all these factors (Tax Morale, Psychological Contract, Perceived Fairness) in a unified way is yet to be developed in order to explain tax revenue at the macro level.

b) Need for complete theoretical approach

The bulk of research is in the area of microdata or empirical survey of defined countries. The same application can't be used in all the countries. In this paper I will present such a simple and general theoretical framework. Which can give policy makers in any economy a complete blue-print of psychological changes to expand the tax base?

3. THEORETICAL FRAMEWORK

This is a new logical model based on the synthesis of all the theories mentioned in the literature review. Which depicts the psychological factors at the micro level moving to the macro level and impact on the country's tax revenue? A theoretical paper is essentially based on a "theoretical framework". This is the logical structure which shows the relationship of different variables. This paper is a theoretical approach, therefore the economic approach model (Economic Deterrence) and the psychological approach model (Behavioral Economics) were combined into a comprehensive model of "Behavioral Tax Compliance Model". The study finds that the framework is rather polarised towards certain poles:

1. Psychological and economic stimuli (Inputs / Independent Variables)
2. Psychological mechanism of the tax payer (Mediating Mechanism / Psychological State),
3. Total taxes collected (Input / Independent Variable)

3.1 Variables of the Framework:

In order to understand this theory, we split our variables into these sections:

3.1.1 Independent Variables (IVs)

These are those factors that can change the tax-payer's mindset. They have been divided into the following:

(a) The political authority of institutions. Political power of institutions.

1. Audit Probability: Risk of getting caught and having to pay the taxes.
2. Severity of the law: Perceived strictness of the law.

(b) Psychological & Social Factors

1. Tax Morale: The moral attitude of the citizen towards the tax.
2. Trust in Government/Authorities: Confidence in the government/authorities' intentions and integrity.
3. Perceived Fairness: Fairness of the tax system (distributive justice, procedural justice and compensatory justice).
4. Social Norms: Attitudes of the physical environment and society.

(c) Mediating Variables – MVs

These are the psychological conditions which emerge in taxpayer's mind because of the independent variables and influences and affect his ultimate decision:

1. Enforced Compliance: If citizens are ready to pay taxes because they are afraid of what will happen if they don't pay.
2. Voluntary Compliance: Taxation by citizens without coercion based on their trust in the state and their sense of moral obligation to pay taxes.

3.1.2 Dependent Variable

Aggregate Tax Revenue Generation: Total Tax Revenue of the country and the extent of the tax net.

3.2 The theoretical core and mechanism of the Framework.

This is an assumption which states that an increase in tax revenues will not be obtained by raising penalties. It's the product of the psychological dynamics of "power" and "trust. This mechanism can be explained on the basis of the following two routes:

3.2.1 Deterrence Path A:

As long as policy makers only resort to audits and fines (Power of Authorities). Hence, it stokes the tax-payers' extrinsic motivation. This leads to "Enforced Compliance" of the society.

So that this can increase the tax revenue in the short-term, the impact is theoretical. This fosters a negative attitude towards the government among the people. When the government's grip loosens or when there are loopholes for taxpayers to exploit. As soon as tax revenue begins to fall, there is a drop. In addition, the cost of administration of the tax collection is very high.

3.2.2 Path B:

The Psychological Path of Trust, Morale and Voluntary Compliance, the process of obtaining compliance relies on psychological cues, the soldier's sense of duty and his choice to follow orders rather than resisting them.

When the state has captured the people's hearts by their sense of fairness, transparency and public interest. So this gives the people back their faith in the State.

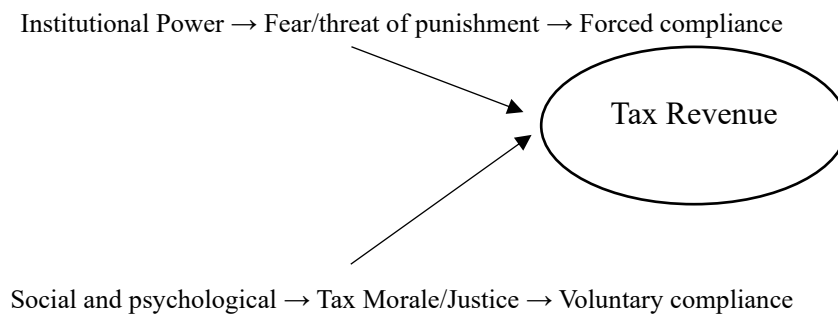
Citizens' tax morale and intrinsic motivation are stimulated with this trust.

Thus a "Voluntary Compliance" is created in society.

Theoretical impact: The long-term sustainable and stable tax revenue is ensured on this path. Tax evasion is considered a moral crime in these days. As a consequence, there is no need for the government to be overly supervised and have a costly audit system. The taxes will be automatically increased.

3.1 Conceptual Framework Diagram

The logical flow of this theoretical framework can be shown through the following structure:



3.2 Basic Assumptions of the Framework

Based on this framework, this paper presents the following key theoretical assumptions:

Hypothesis 1: As taxpayers' trust in the state increases, voluntary compliance will increase, which will increase overall tax revenue on a sustainable basis.

Hypothesis 2: Enforced compliance can only increase temporarily by increasing the severity and power of tax laws. But this crowd-outs tax morale in the long run.

Hypothesis 3: Distributive & Procedural Fairness strengthens the "Psychological Contract" between citizens and the state. Which reduces the psychological incentive to evade taxes.

3.3 Conclusion of the Framework

This theoretical framework addresses this misconception of traditional economics. That man is only a machine that is programmed to pay taxes on profit and loss. Our framework shows that the generation of tax revenue is in fact a psychological by-product. If the state can establish such a level playing field and trust. The place where the payment of taxes is not a duty but a "social pride. Thus the revenue of the country's economy can be maximized, without forcing anyone to pay it. But it is not just an administrative or legal problem to broaden the tax base and raise income. It is a deep social/psychological problem. While states continue to fail to inculcate in the minds and hearts of citizens this trust in money and the fairness of its system. Tax evasion can only be completely eliminated if the system becomes fair, even fines and audits will not do the trick. This research paper calls for the need to shift away from deterrence policy and establish a conducive behavioural environment as the way for sustainable economic growth to be achieved. Where paying taxes is a symbol of 'national pride and voluntary compliance' than fear.

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