

RETHINKING ECONOMICS-OF-CRIME MODEL OF TAX COMPLIANCE FROM BEHAVIORAL PERSPECTIVE APPLIED TO ROMANIAN CASE

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Abstract

Present paper tackles several research paradigms regarding tax compliance behavior that have been used to understand tax evasion phenomenon and tax avoidance behavior of the taxpayer. These notions have been studied by numerous researchers all over the world as phenomenon of tax evasion has a debating issue on every state agenda for several decades. First economic model of tax compliance behavior was developed in the early 1970s and since then researchers improved the model adding new elements from sociology, psychology, legal studies, finance, game theory, neurosciences, econophysics and others. This paper presents the most important developments of current theories regarding tax compliance behavior starting from the “*economics-of-crime model*” till the “*slippery slope framework*” and more. It creates the premises for a Romanian model of tax compliance behavior according to national characteristics regarding taxpayers attitude towards tax avoidance, risk appetite or aversion upon enforcement of law through punishment and penalty, taxpayers’ trust in authority’s efficient spending of tax collected revenue to public budget and personal beliefs regarding notions like morality, cheating, honesty, social responsibility, loyalty, patriotism, civic duty, guilt, fairness, reciprocity or financial incentives. Recent models of tax compliance behavior underline the importance of the dynamics between all the actors involved in the fiscal system such as government, tax authorities, tax consultants and accountants and the behavior of all other taxpayers as a whole. Current research trends believe that these are mutually related. Another important aspect regarding taxpayer’s attitude towards tax avoidance is its own motivation to voluntarily pay taxes driven by intrinsic beliefs or by fear of penalty coming from enforcement of laws. On the contrary, other taxpayers choose to assume an extra share of risk and decide to avoid taxes hiding in anonymity of masses. This paper intends to study the relevance of current models in tax compliance behavior applied to Romanian fiscal system.

Keywords: tax avoidance, slippery slope framework, psychological factors

JEL Classification: K34, K42, G02, H26

Introduction

Assuming that the role of the state is accepted from the paternalistic point of view, authoritarian tax collector offering public services for the society as a whole, than taxes would seem justified by public investments and services offered to citizens and then no one would avoid paying taxes because they understand their specific purpose. But still one question occurs “Why the phenomenon of tax evasion is so wide spread? Why is tax avoidance the fundamental challenge of public finance all over the world?”. This is one of the questions that served as a driving motor for our current research. A lot of research has been dedicated to this subject and still, tax evasion is the greatest of all times. Current research presents several models regarding tax compliance behavior that have been developed in the process of understanding tax avoidance phenomenon and its causes. First economic model of tax compliance behavior developed in the early 1970s has been improved by elements from sociology, psychology, legal studies, finance, game theory, neurosciences, econophysics and others. This paper reviews some of the most important developments of current theories regarding tax compliance behavior starting from the “*economics-of-crime model*” till the “*slippery slope framework*” and more.

1. A short review on various tax compliance models

Assuming that taxpayers are rational, outcome-oriented, selfish who wish to maximize their own utility despite other's satisfaction (Alm et al., 2012a) than a revealing question occurs: “What could drive people to pay taxes voluntarily, not by enforcement or fines?”. This could be one of the premises that authorities target when designing measures to ensure tax compliance. Taxpayers' decision to pay taxes is a complex one and research shows that it cannot be explained solely by a single perspective.

Ensuring tax honesty as an important purpose for tax authorities depends on adherence of citizens to its legitimacy (Picciotto, 2005; Hofmann et al., 2014) and usefulness. A tax code built on principles accepted as fair, legitimate and welfare oriented could offer support to compliant taxpayer behavior.

Insights from behavioral economics could shed some light into the complex nature of tax compliance behavior. Psychological aspects of taxpayer behavior shifts perspective from public authorities' interest and purpose to cumulating resources for public budget towards what are the key drivers lying in human nature that ensure or block voluntary tax compliance behavior. Research shows that intrinsic motivation to cooperate is generated by citizens' trust in governmental policies and efficiency of public investments and negative extrinsic motivation to compliance found in fear of audits and fines leads to a “crowding-out effect” of tax compliance diminishing trust in authorities as audit is perceived as a lack of trust from authorities (Hofmann, 2014). When tax authorities approach citizens as egoistic, outcome-oriented and non-compliant who wish to maximize their utility only than this attitude impacts taxpayers' behavior in a negative way.

Taxpayers exhibit a great variety of behaviors from individual gain maximization to voluntarily or enforced cooperation driven by personal values, norms, personality traits. One taxpayer behavior is shown to be influenced by others behavior towards

tax compliance and also due to the dynamic interaction between all actors in the fiscal system (Alm et al., 2012a,b).

1.1. Classical tax compliance models: economics-of-crime

Research onto tax behavior psychological nature started in the 1970s focusing on tax morality, fairness, personal sentiments towards taxes, individual attitudes (Eriksen and Fallan, 1996), social accepted norms of society and complexity of tax law (Schmölders, 2006).

Classical theory regarded financial transactions from perspective of *homo oeconomicus* acting egoistically under the maximization of personal utility and tax payers' decision to comply was regarded as a purely economic decision under risk. This economic model of tax compliance behavior was developed in the 1970s (Allingham and Sandmo, 1972; Srinivasan, 1973) and followed general theory of criminal behavior (Becker, 1974) to tax compliance.

The classical model of tax compliance is known as the economics-of-crime model that views decision to pay taxes as an individual's choice between a no risk option of paying all taxes and a risky alternative of avoiding paying taxes. According to the audit occurrence probability and severity of punishment the option selected may result in a higher/ lower outcome in comparison to the risk-free option (Allingham and Sandmo, 1972; Srinivasan, 1973; Becker, 1974). This model views tax compliance as a rational decision of a single taxpayer over a risk free and risky assets 'portfolio' (Alm et al., 2012b). If an audit takes place and the taxpayer is discovered cheating the law a fine is imposed and this diminishes the final outcome of the taxpayer with the value of the penalty leaving the individual with less money in the risky option of evading taxes. On the other hand if no audit happens than the taxpayer is left with his entire revenue greater than the risk free option of declaring and paying all taxes. The discovery of the model is that in order to ensure tax honesty tax authorities should increase the number of audits and impose more severe penalties driving the conclusion that the rational taxpayer would pay only by fear of fines.

1.2. Modern tax compliance model: decision under risk and uncertainty

The classical economics-of-crime model has been enriched under current research showing that decision to pay taxes is complex and cannot rely solely as a decision under risk made by a single taxpayer. Firstly because of the variety of "actors" in the fiscal system and the diversity of human behaviors lead by different motivations whose permanent transactions should be taken into account in the process of understanding the tax compliance "game" (Alm et al., 2012a,b). Financial aspects of enforcement could constitute a stimulus for compliance but it has been proven to lead to controversial reactions. In an experimental study conducted taxpayers' compliance increased when the period between a tax record was made and the following audit took place was shorter proving that individuals feared punishment and if probability of a fine was higher people would comply with tax law in order to reduce negative feelings (Mittone et al, 2010). Another experimental study on tax compliance showed that compliance decreased immediately after a tax audit due to misperception of probability for another one to happen and another reason was that individuals showed tendency to repair their losses suffered from a fine coming

from avoiding taxes (Maciejovsky, Kirchler, Schwarzenberger, 2007). Opposite results on tax audits effects were relieved from a simulation study that shown the justice restorative value of a fine and the the “deserving” effect of a punishment for those who disobeyed law (Rechberger et al., 2010). One experimental study on tax compliance showed that compliance behavior increased due to perceived higher probability of an audit occurrence in the short term but not with certainty thus generating expectancies of a perceived audit (Muehlbacher et al., 2012).

Research studying effects of financial incentives show that extrinsic motivation refers to external rewards and intrinsic motivation personal, internal motivation affect behavior. One phenomenon implying financial expected reward or loss refers to the fact that negative intrinsic motivation can outweigh positive extrinsic motivation (Frey, 1997). This behavior can be applied to tax compliance in a way that the negative extrinsic motivation of a punishment could be overcome by positive internal motivation of trust in authorities or sense of civic duty (Wahl et al., 2010; Kogler et al., 2013).

The fact that *individual* motivations can overcome financial aspects is relevant to the study of tax compliance and this could include feelings of guilt, shame, altruism, or patriotism (Alm et al., 2012a,b).

1.3. Behavioral elements add value to the existing models of tax compliance

Another aspect worth taking into consideration is the fact that focusing on a taxpayer in order to study tax compliance behavior shows misses important information coming from other ‘actors’ in the fiscal system that could help into understanding the complex nature of tax compliance. Fiscal system is made up of elements interacting between such as: laws that are given by legal powers and enforced by tax authorities, than taxes are paid by several taxpayers and tax consultants help them in filling their fiscal declarations (Alm et al., 2012b; Kirchler et al., 2014; Muehlbacher and Kirchler, 2010);

Referring to cooperation taxpayers base their actions on judgments about government, authorities and other taxpayers regarding perceived exchange fairness (Kirchler, 1999; Leder et al., 2010). They have strong sense of justice and believe in social norms and willingness to cooperate is showed to depend on taxpayers’ subjective beliefs and evaluations of tax issues and tax representatives attitudes during tax compliance missions. It has also been studied the way that social norms could serve as a stimulus for compliant behavior due to a deep sense of justice (Kirchler et al. 2006).

Although different forms of tax dishonesty produce the same effect on lowering public budget revenue, individuals show different moral perceptions on concepts like tax evasion as being rather negative, tax flight is seen as neutral and tax avoidance is positively perceived due to probably different legal treatment of each one (Kirchler et al., 2003).

Paying taxes is regarded as a contribution to the welfare of a society and public service offerings. But sometimes taxpayers do not perceive the benefits from paying taxes as they would expect to, so perception of fiscal exchange is quite disproportionate in the favor of the state and a minimizing utility of the taxpayer is perceived. It has been studied whether tax compliance increases as awareness of tax laws and relevant rules spreads towards the taxpayers. Results show that transparent and clear communicating methods helping citizens understand public

decisions based on taxes spending are efficient in boosting compliance and the perception of fiscal exchange is more balanced towards increasing utility of the taxpayer so tax compliance is positively affected (Leder et al., 2010).

Another aspect worth taken into consideration is the fact that laws are usually not very easy to understand and therefore put into practice by a common citizen. Tax law is stuffed with a diversity of exceptions written in a language almost inaccessible for a common person to either read or understand it making place to subjective interpretation of tax laws and very different applications found in practice (Alm et al., 2012a,b).

Although taxpayers are aware that taxes are needed to finance public investments some of them may not be aware of the government spending of public revenue or even suppose that some officials benefit in an unfair way of the money. They may even think that there are other individuals who don't pay taxes and they are unsatisfied for the social cost of tax evasion born by those who are honest taxpayers (Wahl et al., 2010; Gangl et al., 2015).

Similar to the premises of rationality and utility maximization of taxpayer according to the classical model, in real life situations a taxpayer still faces the same "social dilemma" (Dawes, 1980). If every taxpayer in the fiscal system decides to maximize its own selfish utility by avoiding taxes harming others taxpayers' interests than this becomes a zero-sum game from which everyone loses because public services could not be offered having insufficient public resources than tax authorities will impose more severe fine and will become more aggressive in collecting taxes so everyone will be negatively affected by this behavior.

In order to overcome this "social dilemma" tax authorities need to promote active measures to build 'trust' in state from the eyes of a taxpayer. Government should ensure that all taxpayers are paying their fiscal obligations and that all taxpayers know tax authorities do their job properly in fulfilling tax enforcement and that public officials use tax collected revenue to welfare projects and not to their own benefit and interest maximization (Gangl et al., 2015; Hofmann E. et al., 2014; Kogler C. et al., 2013).

In real life situations there are individuals who cheat despite the fines expected and others who are honest taxpayers no matter what government does. Other taxpayers act according to the agents from the decision-under-risk model and there are people who at times cooperate but can also speculate tax authorities and rules or others who are lead by social dilemmas and can be influenced by what other taxpayers do or the government presents to the public (Alm et al., 2012a,b; Kirchler, 1999).

There is recent research measuring the impact of values, social norms and taxpayers' attitudes on the scale of tax evasion phenomenon and size of the shadow economy showing that there are differences in tax morality between countries which impact tax compliance behavior (Alm and Torgler, 2006).

Mental accounting is used by practitioners in financial field to accomplish various tasks implying money reporting. In tax compliance filling one's fiscal declaration is an activity that needs economic background and mathematical skills. When filling their fiscal declarations self-employed more than the employed use mental accounting to extract the fiscal obligation from total revenue. When doing this people experience a loss, they felt that money going to paying taxes are negatively perceived as a loss not as a contribution to the welfare of society. In case of self-employed this loss is felt with a greater intensity than for the employed because

they are obliged to pay voluntarily all their taxes and in this case there is the loss-aversion phenomenon occurring showing that they tend to diminish that loss by avoiding taxes (Kahneman and Tversky, 1979; Kahneman et al., 1991). This research is consistent with recent results showing that self-employed taxpayers are avoiding taxes at a higher rate than the employed (Kogler et al., 2015).

One important aspect of current research refers to the fact that government ensuring a climate of trust and cooperation within taxpayers increases tax compliance. Fines and severe audits can achieve greater compliance on the short term because depends on individuals feeling oppressed or coping with deterrence. When feeling oppressed some people tend to act honestly declaring their taxes due to fear and guilt but over the long term deterrence may generate an individual defiance of power and lead to opposite results discouraging tax compliance (Braithwaite and Reinhart, 2013).

Achieving tax compliance lies in the dynamics of power and trust between the various actors in the fiscal system including government, taxpayers, tax authorities and others. Research literature shows several definitions of trust referring to intuitive trust or emotional, rational trust based on internal motivations or reason-based trust (Gangl et al., 2015). Whether a tax authority manage to achieve a public perception as service providers to taxpayers acting on their behalf and for their benefit has proved to be a better measure to ensure tax compliance in a sustainable way (Alm et al., 2012a). The classical and most used model of tax authorities as superior powers using enforcement to achieve tax compliance has proved to be addressed by taxpayers through defiance or resistance.

A very used model of tax compliance behavior is the "slippery slope framework" (Kirchler et al., 2008). The model has been tested and extended since its birth and has proved that establishing an honest climate based on trust in authorities acting as service providers, characterized by respect between tax authorities and taxpayers reduces antagonistic interactions and increases voluntary cooperation and trust at its turn consolidates power (Gangl et al., 2015, 2016; Kogler et al., 2013, 2015).

2. Methodology, objectives and results of the empirical study

Current research is based on an online study conducted in Oradea, Bihor county from Romania on a number of 180 individuals. People in the sample were randomly selected from various backgrounds and regions, rural and urban. The age of the selected participants ranged from 21-35 years old. Participants were asked to answer 14 questions in an online questionnaire. The items in the study tackled issues referring to tax avoidance, tax evasion, trust in state and its authorities, perception of fiscal system.

Objective of the online study was to measure tax compliance attitudes of Romanian nationality participants regarding voluntary compliance versus enforced compliance as it perceived by Romanian nationals. It also evaluated tax morality and participants' awareness and understanding of fiscal notions and economic issues.

Results show that participants in the sample believe that trust in authorities should be the most important value that a fiscal system should be constructed and consequently would imply that it could sustain voluntary tax compliance. Other important values for ensuring tax compliance are jobs creating, public service climate from authorities, transparency, value for money, social welfare,

predictability, stability. More than 50% of all the participants trust current fiscal system, its authorities and tax laws. Most people believe in the welfare state and public service oriented state. Most of participants people believe that a higher number of tax audits at shorter periods of time could enforce tax compliance and achieve cooperation along severe punishment and higher fines for tax cheating. Another aspect worth taken into consideration is the fact that a greater level of comprehensibility of fiscal laws could boost voluntary compliance as the majority of participants have declared. In the same category are fiscal incentives offered to honest taxpayers paying their fiscal obligations in advance could increase voluntary tax cooperation. State offering financial aid to business hiring people and creating jobs could also help increase voluntary tax compliance. Patriotism is another important value of Romanian citizens even in fiscal issues as almost 50% of people would place their business in their national country while another equal share of participants would choose the country offering the best market possibilities to earn higher profits.

Regarding the issues that Romanian citizens are concerned about current fiscal system refers to corruption, fraud on public funds, higher number of taxes, social injustice, authoritarian position of the state, inefficient public spending, bureaucracy, fiscal contradictions, inefficiency of public tax collecting system, instability, lack of transparency in public spending, lack of quality in public services, too higher tax rates, officials acting on their interest not for society welfare, uncertainty in the fiscal system, legal instability, lack of trust, higher rates of tax evasion, weak public communications regarding fiscal issues or tax laws, lack of fiscal justice, too general tax laws that leave space for subjective interpretation, not sustaining welfare and economic growth, higher public deficits, lack of credibility and predictability, illegal activities, incapacity of tax authorities to tackle and control tax evasion and punish tax cheating, weak level of competence in tax collecting and others. Although majority of participants trust actual fiscal system they are very dissatisfied of the public services offered and the fiscal exchange is perceived as imbalanced hurting citizen's utility and benefit from paying taxes.

3. Conclusions

After reviewing the most important tax compliance behavior models our research builds the premises for a Romanian model of tax compliance according to national characteristics regarding taxpayers attitude towards tax avoidance, risk appetite or aversion upon enforcement of law through punishment and penalty, taxpayers' trust in authority's efficient spending of tax collected revenue to public budget and personal beliefs regarding notions like morality, cheating, honesty, social responsibility, loyalty, patriotism, civic duty, guilt, fairness, reciprocity or financial incentives and due to the dynamics between all the actors involved in the fiscal system such as government, tax authorities, tax consultants.

Another important aspect regarding taxpayer's attitude towards tax avoidance is its own motivation to voluntarily pay taxes driven by intrinsic beliefs or by fear of penalty coming from enforcement of laws. Present research shows that Romanian people have a strong set of core values that if could be targeted than voluntary tax compliance in wouldn't be a surprise. This paper studies the relevance of current models in tax compliance behavior applied to Romanian fiscal system and shows that people attitudes towards tax compliance behavior are consistent with current

research trends and believe that the most important element of voluntary tax compliance could be trust in state and its authorities by the latter offering good quality public services and stimulating economic growths through fiscal instruments. Romanian people believe that state through its fiscal system should and could ensure the basis for competitive economic development and create premises for a welfare state.

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