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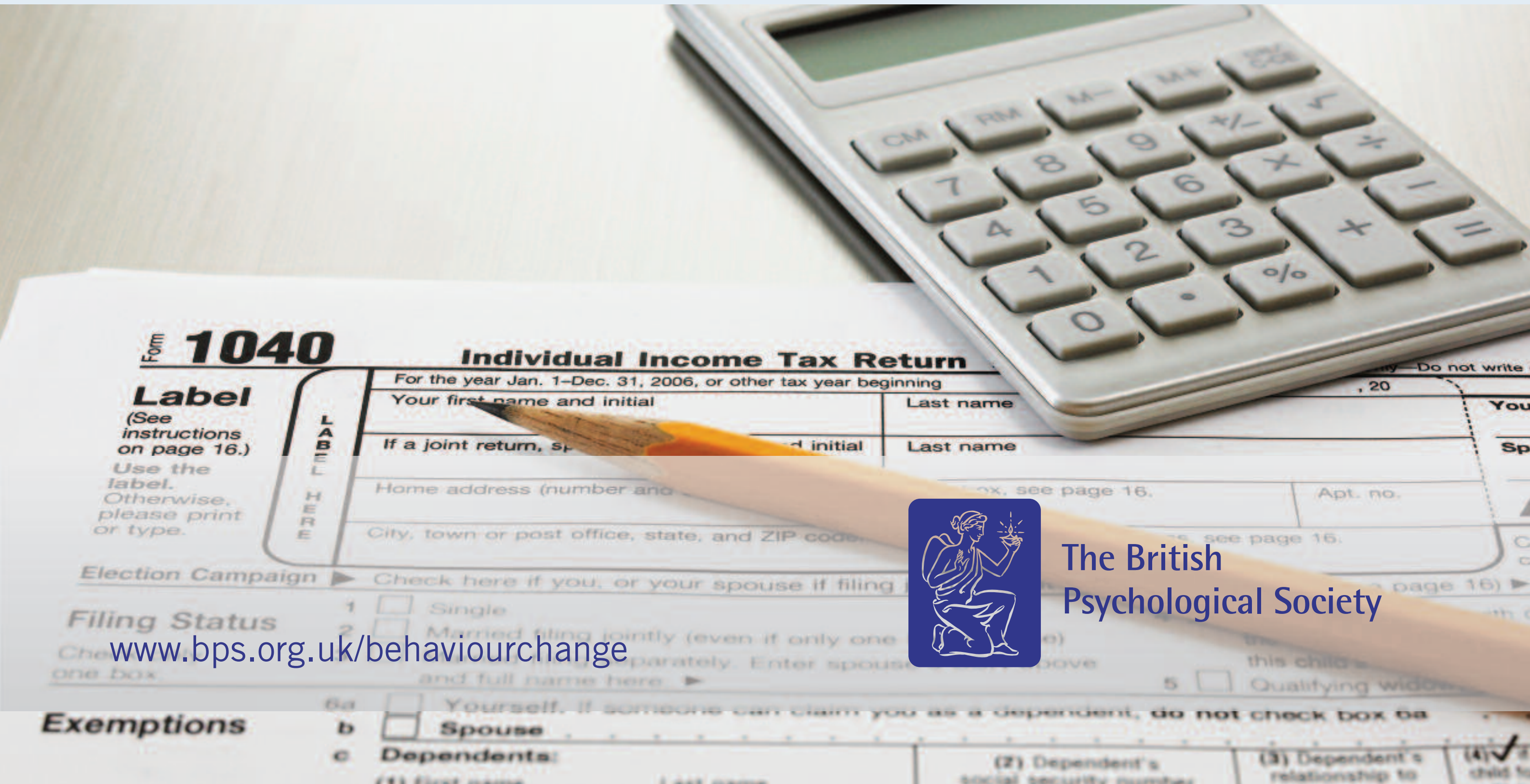
Behaviour Change:
Tax & Compliance

The ‘hidden economy’ is defined as economic activity that is hidden from official transactions, much of which is in the form of tax evasion. It is estimated that some 10 per cent of GDP in the UK and as much as 20–30 per cent in Greece and Italy is lost to the authorities in this way.

The Challenge

The predominant approach to the problem is based on ‘cops and robbers’. In this case tax evasion is seen as a gamble where Rational Economic Man (REM) wants to keep his money and is only deterred from doing so by the threat of an audit and by fines. REM is driven by self-interest alone.[1] Changing behaviour then becomes the relatively simple task of working out the most efficient audit probabilities and sizes of fines.

Insights from psychology provide better ways to reduce tax evasion and increase voluntary compliance



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The Psychology and the Evidence

There are three alternative models: the first is based on behavioural economics and 'nudging'; [2,3] the second on insights from cognitive and especially social psychology covering tax perceptions, tax morale, fairness and justice and the role of social norms;[4,5,.6] the third, co-determination between customers and government.

Behavioural economics: A good example of the first model is Kahneman and Tversky's 'Prospect Theory'[7] where under certain conditions, it can be demonstrated that the majority of people are risk averse for gains and risk seeking for equivalent losses.

There are practical applications of prospect theory and tax compliance. In the United States many people are over-taxed during the tax year, resulting in a tax rebate when tax forms are filed by taxpayers. Alternatively, it is common for traders in the UK to declare their income at the end of the tax year resulting in a payment to HMRC. In the US the process is framed as a gain but in the UK it is framed as a loss (it is common for UK traders not to put money aside in a different 'mental account' for tax purposes, separate from their general accounts). This interpretation is supported by Kirchler & Maciejovsky[8] who found an unexpected refund led to high compliance whereas a surprise demand led to low compliance. Analysis of US Internal Revenue Statutes shows that compliance decreases after demands for supplementary payments.[9, 10]

Insights from psychology: The second model maintains that if taxpayers have favourable attitudes towards revenue authorities and a positive 'tax morale', believing, for example, that tax evasion is wrong, then this will lead to more compliance. Alm and Torgler[11] have demonstrated a positive relationship between tax morale and tax compliance internationally.

Much of the analysis discussed so far has been individualistic. Wenzel[6] has emphasised the importance of social norms in compliance; what other people are doing and what other people expect of you. This resonates with Ajzen and Fishbein's Theory of Planned Behaviour,[12] where the introduction of subjective norms improves the correspondence between attitudes and behaviour.

Implications for behaviour change based on these approaches are broader than those which rely on findings in behavioural economics but may be more long lasting.

It is clearly important that taxpayers feel that the system is fair, trustworthy and just[5] and that money is well spent. Unfortunately not many taxpayers make the connection between the costs of taxation and the benefits of public expenditure. There is evidence that tax attitudes improve when the link to public expenditure is made.[4] There is a policy option to make this link explicit on tax returns, or perhaps allowing taxpayers to express their public expenditure preferences on a tax return.

Co-determination between customers and government: The third model stresses that it is not just a question of a person choosing to change themselves, or a government (or another authority) wanting to change taxpayers as the two are interlinked. Schmolders[13] was one of the first to acknowledge that enthusiastic pursuit of taxpayers with the sticks of audits and fines could

Prepared by **Professor Alan Lewis** on behalf of the Behaviour Change Advisory Group.

backfire, creating more resistance. That treating taxpayers like REM would in turn legitimise the same behaviour. Or put another way, as described by Frey and Stutzer,[14] that intrinsic motivation can be 'crowded out' by insensitive extrinsic economic instruments.

Frey and Stutzer (2008) also make the point that policy interventions need to be targeted to particular segments. Appealing to intrinsic motivation based on civic duty and responsibility may be entirely appropriate for those taxpayers who are not gamblers at heart, whereas the threat of audit and fines is appropriate for those who are.

The interaction between government policy and taxpayers is a central theme of the work of Kirchler[15] who stresses the need for trust, acceptance of the legitimacy of tax authorities and motivational co-operation, as opposed to resistance. 'Cops and robbers' should be replaced by 'service and client'. Similarly, Braithwaite[16] has examined reforms in the Australian Tax Office (ATO) where there has been a change of culture away from resource-intensive enforcement to ways of increasing commitment and voluntary compliance. As a result of this change, which began in the 1980's, both private and public organisations have become more service-oriented and transparent. A charter introduced at ATO for both parties (taxpayers and tax authorities) was not easy to accept at first in a cultural climate of 'command and control'.

The central idea is to concentrate on encouraging voluntary compliance, only resorting to command regulation and prosecution when taxpayers become resistant. The ethos is that 'compliance and integrity can be boosted by investing in the human dimensions of taxpayer management'.[16]

Her Majesty's Revenue and Customs (HMRC)

Certainly some civil servants (and especially in the HMRC Behaviour Change Team, who work closely with the Behavioural Insights Team previously in the Cabinet Office) embrace many of the 'nudging' initiatives recommended by Thaler and Sunstein.[3]

The HMRC Behaviour Change Team are engaged in a series of randomised controlled trials. The first of these tested the influence of social norms on tax debt payments.[17] Letters were sent to 140,000 taxpayers, and took four forms. The first was the standard letter with no mention of social norms (the control group), the remaining three all contained the statement '9 out of 10 people pay their tax on time' in the context of either Britain as a whole, for the taxpayers' postcode, or taxpayers' home town. The interventions appeared to be successful: 67.5 per cent made payments in the control group; 72.5 per cent for national social norms; 79 per cent for postcode social norms and, finally, 83 per cent for home town social norms. It is estimated in the report that the difference between the standard letter and the highest performing home town social norm letter (15 per cent) could advance £160 million of tax debts to HMRC over a six-week period.

Results from other randomised trials have yet to be published and include signing declarations as honest and accurate at the start of the tax return instead of the end, and making taxpayers aware of the fiscal connection between tax paid and public expenditure. HMRC is also running a 'Plumbers Tax Safe Plan' to encourage taxpayers who pay less tax than their counterparts on average and therefore are likely to have outstanding tax liabilities, to come forward voluntarily to put their tax affairs in order.

Recommendations

The efforts made by HMRC are to be applauded but some cautionary observations are apt. For example, reference to social norms on the letters to taxpayers may increase compliance in the short term but if all letters mention social norms in the future, then the effectiveness of the intervention will diminish over time, perhaps even falling below current compliance levels. What matters more in the long term is maintaining a positive tax morale, trust and legitimacy of tax authorities and government as a whole. The nudging initiatives must be part of this endeavour and not work against these longer term aims.

There are essentially four models in operation: cops and robbers; nudge; illuminating the black box; and the co-dependence of government and taxpayers. Both within the HMRC and all international tax administration organisations there are a raft of policies which draw on all four models (where cops and robbers still dominates in the case of HMRC). It is far from clear how successful each of these models are, for whom, and how they interact. Authorities need to evaluate these if they are prepared to reveal this in the new world of increased transparency.

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