
# TAX AVOIDANCE:
## Between Temptation and Trouble

BY MATTHIAS KASPER AND ERICH KIRCHLER

**Fostering tax compliance is a key challenge for global politics. Public revenues need to be protected, and confidence needs to be restored in a system that is deemed ineffective.**

Conservative estimations indicate that the revenue loss from profit-shifting, a form of corporate tax planning, amounts to USD 100 to 240 billion annually. This is 4 to 10% of global corporate income tax (CIT) revenues (OECD, 2015).[1] For developing countries, which rely strongly on revenues from CIT, this ratio is even higher. Consequently, fostering tax compliance is a key challenge for global politics in order to protect public revenues and to restore confidence in the system. But as compliance behaviour is a complex, multi-faceted phenomenon, this is not an easy task.

Multinational corporations have several opportunities to reduce their tax burden. One common and highly effective practice is to shift profits to low tax jurisdictions. Dyreng et al. (2008)[2] show that more than a quarter of US multinationals pays less than 20% in corporate income taxes and Oxfam, a UK based not for profit organisation, estimates that the 50 largest US companies hold USD 1.4 trillion in cash offshore to avoid paying taxes in the US (Oxfam, 2016).[3] In theory, the law distinguishes between legal tax avoidance and illegal tax evasion, but in practice this distinction is often blurred. Global firm structures and complexity in tax law make the allocation of profits an extremely difficult task and many countries lack capacity to protect their tax bases from profit shifting. But moreover, corporate tax avoidance weakens the payment morale of non-corporate taxpayers who perceive that multinationals are not paying their fair share.

With their reputation at stake, firms become increasingly careful around the pitfalls of international tax planning. Graham et al. (2014),[4] for instance, analyse the effects of reputational concerns and the risk of adverse media attention on corporate tax planning. 70% of the executives in their sample state that reputation is an "important" or "very important" factor in their decision not to engage in aggressive tax planning strategies. Their findings indicate that particularly large, profitable public firms are concerned about the reputational effects of tax planning. This is in line with findings from Hanlon and Slemrod (2009)[5] who find that stock prices of multinational firms respond negatively to revelations about their involvement in tax shelters. But as corporations are still struggling to find the "optimal" level of tax avoidance, the fight against aggressive tax planning is gaining momentum and clearly, tax transparency is on the rise. To establish a framework for the allocation of corporate income, the G20 have joined forces with the OECD and developed an action plan to reduce base erosion and profit shifting (BEPS, OECD 2013).[6] Likewise, the European commission is urging for a common consolidated corporate tax base (CCCTB) based on formula apportionment, which would limit multinationals' opportunities to artificially reduce their tax payments. But while research indicates that documentation requirements successfully mitigate profit shifting (Beer & Loeprick, 2015)[7] and the CCCTB might further impede corporate tax planning, the revenue effects of tax harmonisation within the EU remain to be seen (Devereux & Loretz, 2008).[8]

In any case, changing the rules of international tax will not be enough to restore and maintain high levels of compliance. Social psychological research shows that social norms have a significant impact on behaviour (Fehr et al., 2002)[9] and particularly peers shape our compliance choices (Alm et al., in press).[10] In order to curb aggressive tax planning, it is thus crucial to build a sense in society that tax avoidance has severe consequences. A social norm of cooperation needs to be established and taxpayers' identification with this norm needs to be strengthened. To achieve this, a sound understanding of the determinants of taxpayer behaviour is crucial. Psychological research indicates that tax authorities' power to enforce the law as well as taxpayers' trust in authorities drive compliance behaviours. Against this background, policy makers and revenue bodies need to understand the dynamics between trust and power in order to establish a climate that promotes trust and fosters cooperation.


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### Attitudes Towards Taxes

Tax revenues fund public goods. They are used to stimulate or impede certain behaviours and allow redistributing wealth. But while taxes are imperative, taxpayers' attitudes towards taxation are, at best, mixed. Sussman and Olivola (2001)[11] show in a series of experiments that many consumers are tax averse: they rather avoid paying taxes than avoiding equally large, or even larger, non-tax costs. This tendency showed to be particularly strong among individuals who identify with political parties that favour less taxation. However, their tax aversion diminished when asked to consider positive effects of taxation, suggesting that policy makers should highlight the positive implications of taxes in order to increase compliance.

Undoubtedly, the vast majority of taxpayers are willing to pay their taxes correctly (Frecknall-Hughes & Kirchler, 2015).[12] Unfortunately, however, most tax systems are incredibly complex and tax system complexity is one of the most serious impediments to voluntary compliance. The US tax code, for instance, comprises more than 4 million words. Its' volume has increased steadily since 1955 (Owens & Hamilton, 2004)[13] and the Taxpayer Advocate Service, a federal institution that assists taxpayers in solving their issues with the IRS, stresses that, on average, more than one provision is added to it daily. Tax law complexity imposes substantial compliance costs on corporate taxpayers. Moreover, it undermines taxpayers' ability to understand their payment obligations. This, in turn, challenges fairness perceptions and stimulates misunderstandings, breeding suspicion, fear, and mistrust. Consequently, it is not surprising that many taxpayers find tax avoidance acceptable.

Two studies conducted in Austria (Kirchler, 1998[15]; Kasper et al., in press[16]) asked taxpayers to describe and evaluate *tax evaders*, *honest taxpayers*, and *typical taxpayers*. The more recent study also

Figure 1a: Evaluation and description of different types of taxpayers. Kirchler (1998)

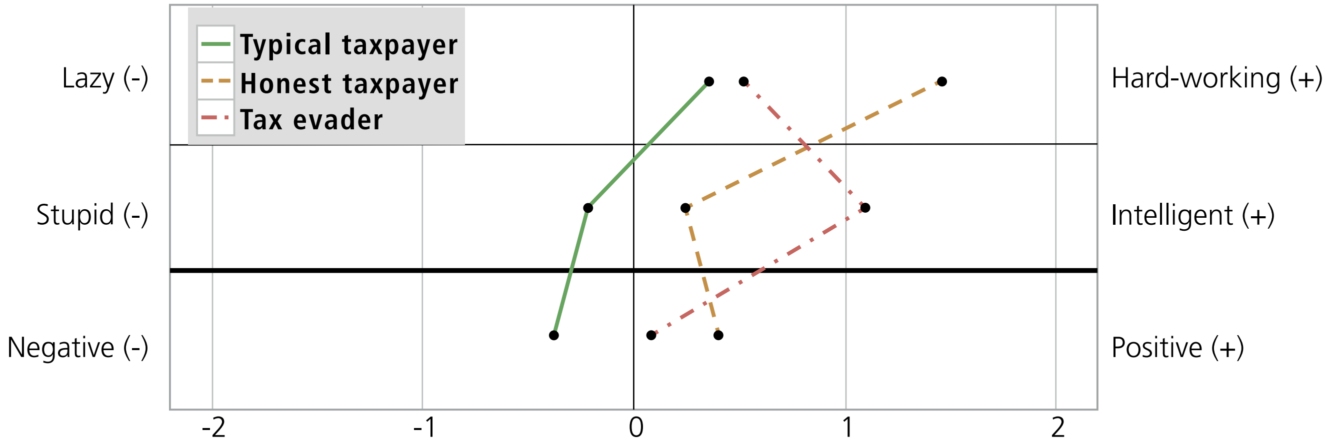
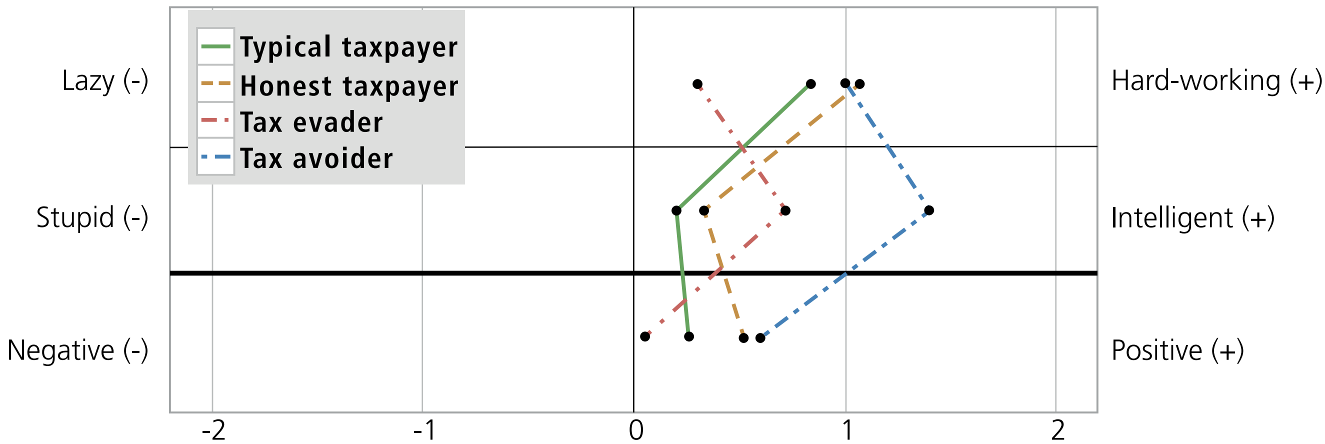



Figure 1b: Evaluation and description of different types of taxpayers. Kasper et al. (2016)




incorporated *taxpayers legally avoiding taxes*. Results from the 1998 study, depicted in Figure 1 (above), show that tax evaders were evaluated neutrally and perceived as intelligent, and rather hard-working. Honest taxpayers, on the other hand, were evaluated positively and described as hard-working, but less intelligent than tax evaders. Surprisingly however, typical taxpayers were judged negatively, relatively lazy, and not very intelligent. As the recent data shows, the evaluation of these types of taxpayers has not changed much over the last two decades. And despite the ongoing debate on corporate tax planning, taxpayers who legally avoid paying taxes are perceived as hard-working and intelligent.

Refining these results, a study from Germany[17] shows that the majority of taxpayers finds it important and necessary to comply. However, many taxpayers perceive their tax burden to be high and the tax system to be unfair. They criticise complexity in tax law, compliance costs, and poor effectiveness of public spending. In order to increase taxpayers' willingness to comply, it is thus crucial to reduce tax law complexity, to provide sound taxpayer services, but also to invest public funds more sustainably.

## Coercion or Voluntary Cooperation?

On a theoretical level, taxpayers' choices to pay their taxes honestly or to evade is a decision under risk, where compliance certainly reduces the gross income, while the consequences of evasion depend on the audit probability and fines for non-compliance. Indeed, various studies indicate that audit rates and punishment for non-compliance impact on compliance. But as audit probabilities are often low while aggregate compliance levels show to be relatively high, other factors seem to matter too.

A substantial body of evidence from economic psychology and behavioural economics finds that audits and fines are less effective than theoretically expected. For instance, a recent study shows that tax audits may have negative effects on reported income of sole proprietors, if they do not result in additional tax assessments (Beer et al., 2015),[18] indicating that reliability in detecting non-compliant taxpayers is a crucial feature of effective audit schemes. On the other hand, audits may lessen taxpayers' willingness to comply, if they perceive audits as arbitrary. Linking audit frequencies to different measures of tax compliance, Mendoza et al. (2015)[19] find that that audits might weaken voluntary compliance when they are conducted excessively. This line of research suggests that breaching the *psychological contract* between citizens, authorities, and the state has negative effects on tax compliance behaviour.[20] Taken together, these findings show that promoting a cooperative relationship between revenue bodies and taxpayers is crucial. Instead of relying exclusively on audits and fines to increase compliance, tax authorities should aim to provide comprehensive taxpayer services and to build trust.

The *slippery slope framework* formalises research on the determinants of tax compliance behaviour.[21] As indicated in Figure 2 (on right) it assumes that tax authorities' power, that is their capacity to enforce the law, can elevate compliance levels. In this case, however, taxpayers comply because they fear punishment rather than because they are convinced of doing the right thing. Conversely, trust in tax agencies stimulates voluntary cooperation. Both trust and power are important to establish high levels of compliance and the framework predicts lowest compliance levels if taxpayers do not trust the authorities and agencies lack capacity to detect and prosecute non-compliance. If trust levels and revenue bodies' power are high, on the other hand, taxpayers cooperate voluntarily because they believe paying taxes is the right thing to do and because they feel protected from free-riders.

A series of laboratory and survey studies confirms the assumptions of the slippery slope framework. Kogler et al. (2015),[22] for example, find strong correlations between compliance levels and trust, respectively power among 500 self-employed taxpayers in Austria (Figure 3 on next page). Trust in authorities shows to be closely linked to voluntary cooperation, while perceptions of high power translate to enforced compliance. As expected, lack of trust and power decrease compliance levels to a minimum.

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## Implications and Outlook

Psychological research indicates that tax compliance behaviour is a complex, multifaceted phenomenon. Policy makers begin to realise that deterrence and coercion alone are not enough to establish high compliance levels. Instead, they develop *cooperative relationships* with multinational corporations aiming to reduce compliance costs and increase legal certainty. But sound legal frameworks and a more service-oriented approach to tax administration are not only crucial for businesses. They also impact on perceived fairness in taxation, which in turn has positive effects on tax morale and taxpayers' willingness to pay.

Research on taxpayer behaviour indicates that modern tax administration needs to take a nuanced approach. First, most tax laws are overly complex and simplification is much needed. Second, it is essential to provide comprehensive taxpayer services, because many people do not understand the intricacies of tax law and consequently find it hard to comply with their payment obligations. Third, various studies show that a trustworthy relationship between authorities and taxpayers promotes voluntary compliance.

Figure 2: The slippery slope framework of tax compliance

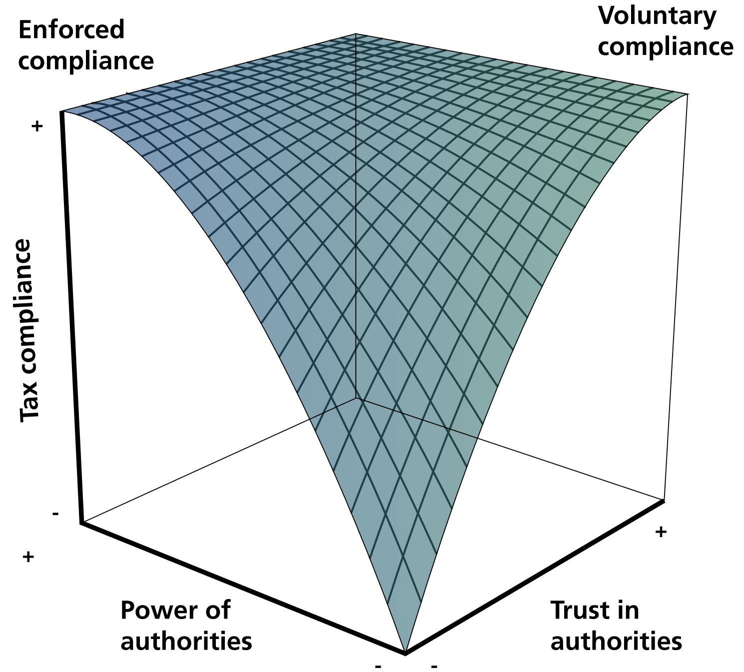
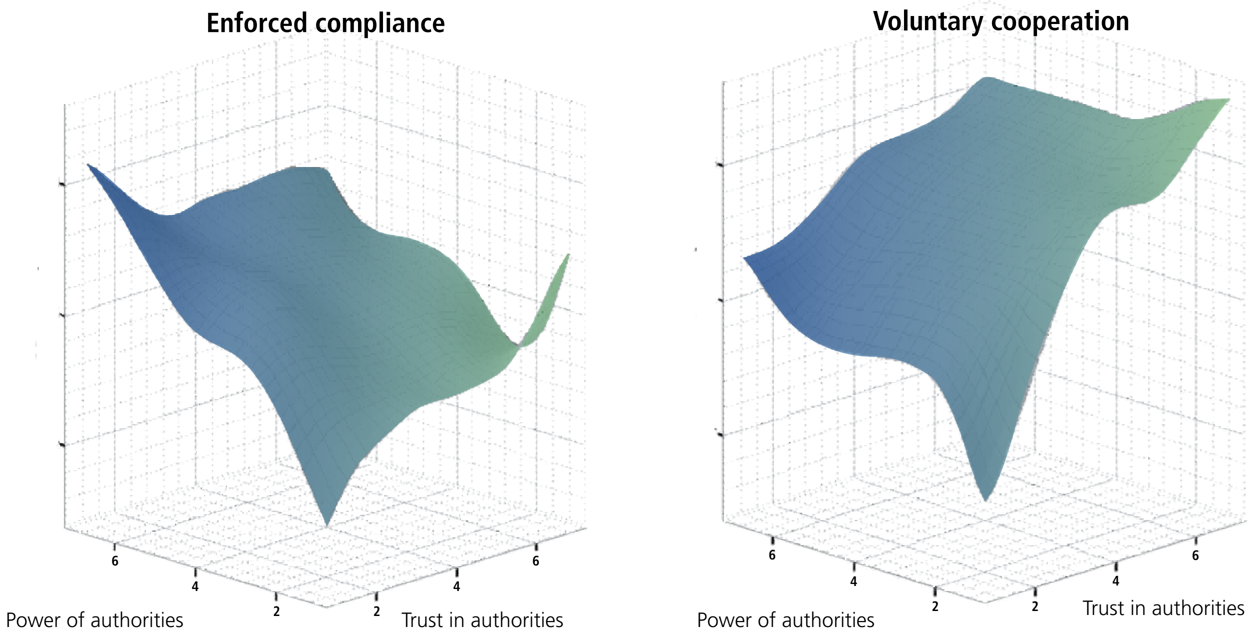


Figure 3: Enforced compliance and voluntary cooperation




It is therefore important that taxpayers perceive revenue collection, but also the redistribution of public funds transparent and fair. Fourth, because social norms shape compliance behaviour, it is necessary to strengthen taxpayers' identification with the community in order to stimulate cooperation.

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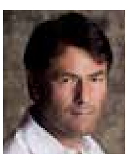

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