

The art of dodging

Erich Kirchler analyses why people avoid paying taxes and shows that public trust in the authorities can play a strong part in achieving better rates of compliance

Most countries make a legal distinction between tax evasion and tax avoidance. Clearly, both evasion and avoidance aim to reduce the final amount of tax paid. However, while evasion means deliberately breaking the law, avoidance takes a more creative approach: accounting for income and deductions in line with the letter – if not the spirit – of the law, with the aim of minimising contributions.

Companies that operate globally invest in many different jurisdictions, which gives them the opportunity to develop tax planning schemes that allow them legally to cut their tax liabilities to a minimum. Such tax avoidance strategies are common and include shifting income into tax havens, using complex hybrid securities that can be written off against tax and making use of other tax shelters.¹

Aggressive tax avoidance schemes have become a major competitive factor for large companies and for the countries that help facilitate them, leading to steadily declining corporate tax rates in the European Union and the US. Dyreng et al. (2008) found that more than a quarter of publicly traded US companies are able to cut their tax liability to less than 20 per cent of their pre-tax earnings, and are able to sustain these low rates of taxation over a long time. Martin A. Sullivan (2012) described tax avoidance strategies by highly profitable multinational companies that enabled them to reduce drastically their taxes on worldwide income. For instance, effective tax rates on the non-US profits of Apple and Google have been reported to be less than 3 per cent.²

Drastic reduction in tax liability by large companies has triggered intense public debate and brought taxation to the top of the international policy agenda. The OECD is releasing recommendations on how to combat aggressive tax planning (see www.oecd.org/ctp/administration/Co-operative-Compliance-Preliminary.pdf). Policy options³ include tackling profit shifting and tax avoidance by multinationals.

The ways and means include the extension of source taxation, residence taxation and fundamental reform of corporate income

'Lying to the IRS does not cause the same outrage as lying to shareholders'

taxation as well as stricter reporting and transparency requirements. Many emphasise the necessity of building an international

consensus on developing instruments to control and influence the strategic behaviour of multinationals.⁴ The problem, however, is that the tax-planning strategies of multinationals are not – at least

as things stand – illegal.

Besides legal and political measures, it is, therefore, necessary to establish just what society considers wrong or right when it comes to tax. Aggressive tax planning may have the advantage of maximising the value of a company and making shares more attractive, which clearly has benefits both for shareholders and executives.⁵ However, companies identified as applying aggressive tax strategies may bear reputational and political costs thanks to being labelled a "poor corporate citizen".⁶

Concerns about reputational costs can, therefore, be a factor in limiting tax avoidance. Indeed, researchers⁷ report that public scrutiny can affect companies' behaviour: in 2012, media reports revealed that Starbucks paid just £8.6m in corporate tax in the UK over 14 years despite revenues of around £3bn. The negative publicity resulted in customer boycotts of Starbucks stores and significant drops in the company's reputational ratings. Eventually, the reputational damage prompted the company to pay taxes and relocate offices to the UK.

Graham et al. (2014) studied 600 US corporate tax executives' incentives and disincentives for tax avoidance.⁸ While the most important reason given for not implementing a tax strategy was that "a transaction lacked business purpose or economic substance", potential reputational costs ranked second overall, which goes some way to explaining why not all companies adopt aggressive tax planning strategies.

Consumer reactions to "poor corporate citizens" seem not to be long lasting and, as Hanlon and Slemrod (2009) found, they depend on the industry, being especially powerful in the retail sector. Tax avoidance may not even be seen as particularly criminal. "Lying to the IRS doesn't generate the same public outrage as lying to shareholders. In some quarters of the country, it is almost seen as a patriotic act," the research found.⁹

To combat aggressive tax avoidance effectively and to increase equitable payment of tax, it is necessary to establish a sense in society that both tax avoidance and tax evasion are wrong. Mutual cooperation must become the binding social norm and people's identification with the norm needs to be strengthened. How might this be achieved? First, it is necessary to understand people's attitudes and how taxation and taxes are represented within society. Second, a climate of mutual civic cooperation needs to be established, based on the power of authorities and people's trust in those authorities.

5. Hanlon and Slemrod (2009, p. 126).

6. Ibid.

7. Dyreng et al. (2014, p. 10).

8. Graham et al. (2014).

9. Murray (2002) A4; quoted in Graham et al. (2014, p. 993).

10. Freiberg (2010, p. 122).

1. Gallemore et al. (2014).

2. (2012), quoted by Fuest et al. (2013).

3. Fuest et al. (2013).

4. See, for example, Hey et al. (2013).

Attitudes towards taxes

Revenues are collected by the state to fund public goods such as security, education and roads. Taxes, charges and levies serve also to regulate the behaviour of citizens and organisations, and to influence markets. For instance, they are used as an incentive to eating healthy food and to encourage taking part in environmentally friendly activities. Equally, tax can be used as a disincentive to undesirable, but legal, behaviour such as excessive energy consumption.¹⁰ Taxes are also a policy instrument applied to redistribute wealth in the society. However, despite the advantages that accrue to citizens from state investments in public goods, their attitudes towards taxes are, at best, mixed. Thomas Aquinas (1225-74) is frequently quoted as having dubbed taxes “legal theft”. Peter Sloterdijk, the German philosopher, accuses the current fiscal system of being an ignoble relic of an absolutist state kleptocracy.

A reluctance to pay taxes not only seduces taxpayers into looking at possible ways of legally, or illegally, reducing their tax burden but also leads them to take on additional costs in order to avoid taxes. In their experimental study, Sussman and Olivola (2011) showed that consumers considered goods advertised with a VAT-related sales discount to be more attractive than goods with a regular sales discount.

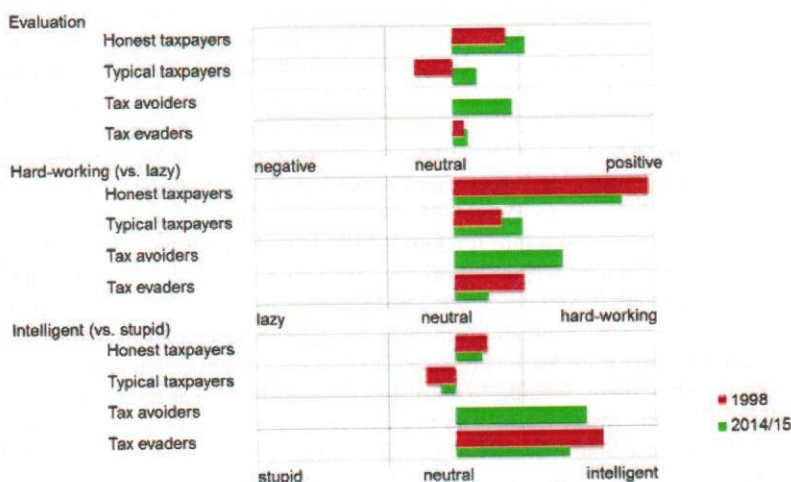
The form of the tax legislation itself can also be a disincentive to paying tax. In particular, tax law is accused of being extraordinarily complex. From 1955 to 2000, for example, the number of words in the US IRS tax code is said to have quadrupled.¹¹ It is not only ordinary taxpayers who find it difficult to understand tax law. Tax authorities and tax advisers claim that it is hard to draw the line clearly between legal and illegal acts. People generally blame the complexity of tax law if they feel incompetent in dealing with taxes and consider it necessary to consult tax advisers.

The demand for the services of tax advisers does not seem to be primarily driven by the desire to avoid paying taxes, however, but by the motivation to report taxes correctly while paying no more than is absolutely required.¹² Past attempts to simplify the law have tended to fail, as US congressman Delbert L. Latta made plain in 1985 when he said: “I hold in my hand 1,379 pages of tax simplification.”

Although taxes need to be nuanced in their application to avoid stifling the various economic activities that a developed economy requires, complexity produces misunderstandings and ignorance, which breed suspicion, fear and mistrust. Consequently, it is not surprising that people regard taxes ambivalently and see ways of reducing their taxes as acceptable. Austrian taxpayers, for example, have been asked in two studies – carried out nearly 20 years apart – to describe and evaluate “typical taxpayers”, “honest taxpayers” and “tax evaders”.¹³ The 2014 study also asked respondents for their perception of those “taxpayers legally avoiding taxes”. As shown in Figure 1, two decades ago, tax

evaders were evaluated neutrally, whereas typical taxpayers were judged negatively. Tax evaders were described as being intelligent and rather hard-working, whereas typical taxpayers were described as being rather lazy and not very intelligent. Honest taxpayers were perceived as hard working but less intelligent than evaders. Two decades later, the picture has not changed much. Overall, Austrian taxpayers see avoiding taxes as a rather clever act by intelligent and hard-working people.

Fig. 1. Evaluation and description of typical taxpayers



Recent success by authorities in limiting the activity of tax havens and in fighting large-scale tax evasion – together with the public shaming of global companies that avoid tax, has led to greater awareness of the necessity of taxes and the damage caused by evasion and avoidance strategies. A study of the attitudes toward tax and paying taxes in Germany¹⁴ shows that the population still considers it important to comply with the law on tax. However, while belief in the importance of tax compliance is high, people also find the tax code much too complex and want the state to invest more intelligently and fairly in public goods. Of those surveyed in the study, 95 per cent believed that the state was much too wasteful with their money and 85 per cent complained that taxes were too high.

'I hold in my hand 1,379 pages of tax simplification'

It is not easy to change attitudes like those. There is, however, an OECD-initiative on “cooperative compliance” that aims at increasing mutual trust between tax authorities, government and citizens.

Enforced compliance – voluntary cooperation

The problem for any state that wants to increase mutual trust is that taxpayers can decide either to declare taxes honestly,

14. Bund der Steuerzahler Nordrhein-Westfalen, (the association of taxpayers of North-Rhine Westphalia) (2014).

11. Owens and Hamilton (2004).

12. Fecknall-Hughes and Kirchler, 2015; Sakurai and Braithwaite (2003).

13. Kirchler (1998), (2014).

paying what is required and disposing of the remainder of their income with a sense of security, or choose the risky option of engaging in tax evasion. If no tax audit takes place, evaders are better off than honest taxpayers. However, if tax evaders are caught and forced to pay the undeclared tax as well as a fine, they will ultimately have less money at their disposal than if they had declared their taxes honestly.

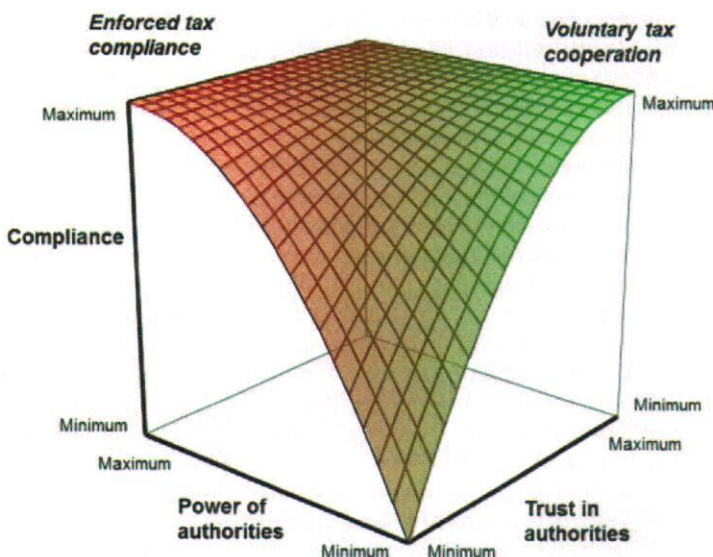
Research suggests that a high probability of facing an audit, especially when it is backed by severe fines, prevents people from evading taxes. However, there is overwhelming evidence from behavioural economics and economic psychology that audits and fines are far less effective as a stick than might be expected. In fact, they sometimes have the opposite effect to that desired.¹⁵

It is essential, therefore, to apply audits and fines precisely and cautiously, targeting taxpayers who deliberately evade tax. Otherwise, such controls and sanctions can be counterproductive, undermining the intrinsic motivation to cooperate. They can corrupt what is known as the “psychological contract” between citizens, authorities and the state.¹⁶ What is needed to promote tax honesty is a positive, cooperative relationship between authorities and taxpayers.¹⁷

Policy regulation, though, still believes in audits and fines as a more general tool to increase compliance. This is particularly unfortunate as audits and fines can have no impact on tax avoidance.

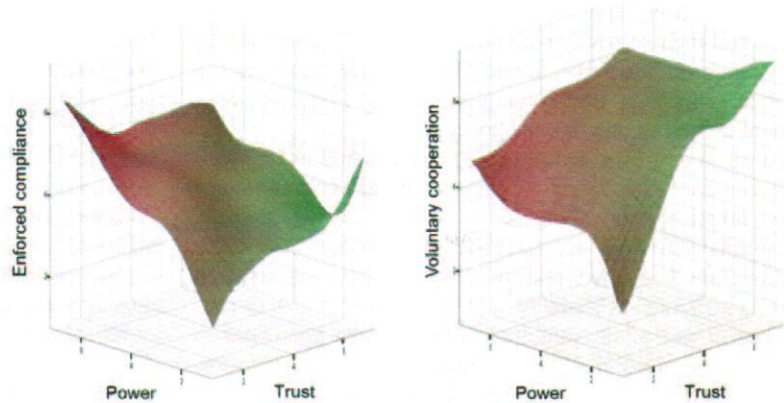
In “the slippery slope framework”,¹⁸ enforced compliance and

Fig. 2 Slippery slope framework



15. Kirchler (2007).
 16. Rousseau (1995).
 17. Feld and Frey (2007, 2010)
 18. Kirchler (2007) and Kirchler et al. (2008).

Fig. 3 Practical implications



voluntary cooperation between authorities and taxpayers and their determinants are described (Figure 2). Voluntary cooperation depends primarily on trust in the state and its authorities. If cooperation does not take place voluntarily, tax honesty can be enforced to the extent that the state authorities have enough power to deter evasion. The framework assumes that tax payments are influenced by trust in authorities and the power of authorities: if both trust and power are low, tax payments are assumed to be low; taxpayers selfishly maximise their own profit through tax evasion. When trust in authorities increases, voluntary cooperation is assumed to increase.

With stronger powers for authorities, enforced compliance is assumed to increase. The power of authorities – defined as tax authorities’ capacity to detect and punish tax crimes – is necessary to protect collaborating citizens from being exploited by free-riders. Legitimate power and well-targeted coercive power are positively related to trust, leading to spontaneous collaboration rather than evasion or strategic avoidance.

The assumptions of the slippery slope framework were empirically tested and confirmed in laboratory and survey studies in various nations. For instance, Kogler, et al. (2015) conducted a survey with about 500 Austrian self-employed taxpayers and found trust in authorities and the power of authorities strongly correlated with compliance. As Figure 3 shows, trust in authorities is strongly linked to voluntary cooperation and compliance, while power is significantly related to enforced compliance. If trust and power are low, compliance decreases to a minimum.

Practical implications

Institutions and authorities have started to recognise that trust-building measures promote voluntary compliance. The paradigm of compliance regulation, therefore, is changing: interaction between authorities and taxpayers known as “cooperative-relationships” and “horizontal monitoring” are being applied in several countries. For example, in 2005, the Dutch tax authorities started switching from traditional vertical monitoring

to horizontal monitoring. While vertical monitoring relies on checking tax files retroactively, horizontal monitoring focuses on fair play, on understanding and transparency between taxpayers and the authorities, and on the planning of future business activities and their respective tax consequences. The interaction paradigm is shifting to a trust relationship between taxpayers and authorities, which is based on a compliance and fair-play agreement as well as on effective tax control.

Reviews of empirical studies in economics and psychology provide evidence about strong determinants of tax compliance that have practical implications:

(a) Audits and fines are necessary to protect cooperative taxpayers from free-riders and to make well-targeted resistant citizens contribute their share.

(b) The power of tax authorities needs to be perceived as legitimate and professional. In particular, tax auditors need to be well trained and to cooperate intensively with legislators, judges and international authorities to combat evasion and aggressive avoidance.

(c) Tax law must be simplified to be comprehensible for taxpayers.

(d) Taxpayers need to be segmented according to their needs and appropriate services must be offered.

(e) Trust in authorities needs to be high. Distributive justice and procedural justice, as well as retributive justice, are very important in establishing and maintaining trust. Revenue collection and investment need to be transparent, and the balance of contributions and participation in public goods by different income earners needs to be perceived as fair.

All in all, measures need to be taken to strengthen people's identification with the community and cooperation must be established as the dominant social norm.

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Audits and fines are needed to protect taxpayers from free-riders



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