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Can ethics change? Enforcement and its effects on taxpayer compliance

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Abstract

'How does tax enforcement affect taxpayer compliance, especially via its effects on tax morale and taxpayer ethics? In this paper we discuss the role of ethics and tax morale in compliance decisions and the effect of enforcement on these notions. We first discuss the factors that shape tax morale and ethics, using these terms as interchangeable concepts. We then summarize prior research that investigates how enforcement affects tax compliance. Subsequently, we discuss how tax morale and ethics shape behavioral responses to enforcement. Finally, we present administrative strategies to mitigate the negative effects of enforcement on compliance via its effects on tax morale and ethics.

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Can ethics change? Enforcement and its effects on taxpayer compliance

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How does tax enforcement affect taxpayer compliance, especially via its effects on tax morale and taxpayer ethics? In this paper we discuss the role of ethics and tax morale in compliance decisions and the effect of enforcement on these notions. We first discuss the factors that shape tax morale and ethics, using these terms as interchangeable concepts. We then summarize prior research that investigates how enforcement affects tax compliance. Subsequently, we discuss how tax morale and ethics shape behavioral responses to enforcement. Finally, we present administrative strategies to mitigate the negative effects of enforcement on compliance via its effects on tax morale and ethics.

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Introduction

How does tax enforcement affect taxpayer compliance, especially via its effects on tax morale and taxpayer ethics? Economic theories of tax compliance assume that taxpayers comply if they assume that their noncompliance will be detected and punished (Allingham & Sandmo, 1972; Srinivasan, 1973; Yitzhaki, 1974). These theories are based on Becker's (1968) economics-of-crime approach, and analyze taxpayers' compliance decisions as decisions under risk: taxpayers decide how much income they report based on the expected utility of the option to pay or evade. Increasing audit and fine rates in case of detected evasion decrease the expected utility of evasion, and thus lead to higher tax compliance. In line with these theoretical considerations, decades of research have produced compelling evidence that frequent and efficient audits fuel compliance (Alm, 2019; Slemrod, 2019; Alm & Malezieux, 2021), and Kirchler et al. (2010) show that audits have a stronger deterrent effect than fines.

The literature identifies two mechanisms through which tax audits increase compliance. The first mechanism, *general deterrence*, refers to the improvement in compliance within the general taxpayer population in response to an increase in the audit rate. The general deterrence effect of tax audits has been extensively studied. The estimated reported income-audit rate elasticity typically ranges from 0.2 to 0.4 (Alm, 2019). However, there is also evidence that high audit levels correlate with high levels of tax evasion (Mendoza et al., 2017). The second mechanism, *specific deterrence*, relates to the effect of audits on the post-audit compliance of audited taxpayers. Prior research on the specific deterrence effect of tax audits finds that audits have a positive effect on the post-audit tax compliance of audited taxpayers (Kleven et al., 2011; Advani et al., 2017; DeBacker et al., 2018). However, other studies suggest that the post-audit behavior of audited taxpayers is mixed. Specifically, these studies find that taxpayers who receive an additional tax assessment as the result of a previous audit report more income in subsequent years, while those who do not receive an additional assessment report less (Gemmell & Ratto, 2012; Beer et al., 2020). Other studies find that taxpayers decrease their compliance after experiencing an audit (Guala & Mittone, 2005; Mittone, 2006).

These findings raise the question whether increasing tax enforcement always leads to more compliance and what may cause backfiring effects. In particular, the question arises whether the audit experience affects tax morale, i.e., a taxpayer's belief that paying taxes is the right thing to do (Alm & Torgler, 2006, 2011) and taxpayers' ethical values, i.e., the guiding principles that help to decide what is good or evil. Indeed, there is strong evidence that taxpayers may not change their tax morale after experiencing an audit and due to fear of punishment. Instead, they may become more strategic in their decisions to pay or not to pay, they may not feel shame or guilt, and they may not experience moral costs when considering to cut their tax obligations. Rather than paying taxes as a moral obligation, paying or not paying taxes may be perceived as a gamble with the goal to win.

A large body of research in psychology and economics has revealed many varied factors that shape a taxpayer's willingness to comply. For example, taxpayers are guided by their own attitudes towards paying taxes (Webley et al., 1991), they are guided by the behavior of others (Wenzel, 2005), and they are also guided by the trustworthiness of the tax agency (Kirchler et al., 2008) and the fairness of the tax system (Andreoni et al., 1998). These factors may determine tax morale in particular and shape taxpayer ethics in general. It might well be that, by observing others' behavior and experiencing and reasoning about fair procedures and outcomes, taxpayers modify their subjective representations about the authorities, the tax system, general compliance in the society and adapt their tax morale as well as their ethical core values. Harsh enforcement via frequent audits that are perceived as unjustified and inappropriate fines that are seen as overly punitive may lead to opposite than intended effects. Governments in general and tax authorities in particular who are not perceived as trustworthy – which requires acting professionally on a legal basis, operating honestly and transparently, viewing taxes from the taxpayers' perspective, and acting benevolently in accordance with the values of its citizens – will likely trigger defiance and disengagement. Non-cooperation with rejected authorities may not only be perceived as justified but also as the right thing to do, and non-cooperation by evading taxes may be judged as ethically correct.

The effect of enforcement on taxpayer ethics remains largely unknown. In this chapter we discuss the role of ethics and tax morale in compliance decisions and the effect of enforcement on these notions. We first discuss the factors that shape tax morale and ethics, using these terms as interchangeable concepts. We then summarize prior research that investigates how enforcement affects tax compliance. Subsequently, we discuss how tax morale and ethics shape behavioral responses to enforcement. Finally, we present administrative strategies to mitigate the negative effects of enforcement on compliance via its effects on tax morale and ethics.

Foundations of tax morale

Morality and ethics are often seen as largely interchangeable concepts, as we do here. Morality describes a set of socially accepted behavioral rules, while the broader concept of ethics results from a reflection on morality and a body of systematic moral principles (Brederode, 1996). The notion of ethics also refers to the practical exercise of morality through behavior (Brederode, 2020). Both concepts build on normative foundations in general and a taxpayer's personal norms in particular. Personal norms – in contrast to social and societal norms - reflect the belief that there is a moral imperative to comply with one's tax obligation (Wenzel, 2005). Similarly, tax morale is often defined as a taxpayer's belief that paying taxes is the right thing to do (Torgler, 2007).

A person's moral conscience develops in several stages throughout an individual's lifetime (Kohlberg, 1969). At the earlier stages, individuals are obedient and egoistic. They do what they are told to avoid punishment, and they base their actions on anticipated costs and benefits. As individuals mature and their morality develops, they become more considerate and more willing to cooperate. Their behavior is now guided by laws and duties that are socially agreed upon. As their morality develops further, individuals feel committed to the principles of fairness, equity, and equality. Finally, in the highest stage of moral development, individuals develop their own personal principles, principles that emerge from social discourse about values and moral standards, as well as from the legal and informal framework that authorities impose. It is through these principles that individuals develop tax ethics and tax morale.

What shapes tax morale? Prior research has investigated a variety of factors that affect tax morale. For example, the literature discusses different aspects of justice and fairness (Colquitt, 2001; Wenzel, 2003). These studies typically distinguish between procedural justice, informational justice, interpersonal justice, and distributive justice. Procedural justice refers to the transparency, consistency, and neutrality of processes, and it is affected by individuals' ability to express their views and to influence the outcome of a decision (Tyler & Lind, 1992). Informational justice and interpersonal justice relate to fairness in interactions (Bies & Moag, 1986), such as justification, truthfulness, respect, and propriety. While fairness in explanations establishes informational justice, interpersonal justice relates to sensitivity and respect in interactions (Greenberg, 1990). Finally, distributive justice results from a match between the outcome of a decision and the goals of the decision. In particular, the tax burden should be allocated fairly across taxpayers with equal (horizontal equity) and with unequal (vertical equity) incomes.

Prior research has also investigated exchange fairness, or the relation between requested contributions and obtained benefits. A study in Australia, for instance, found that students' willingness to repay their student loans depends on their satisfaction with the quality of the educational system, and the willingness to repay student loans was greater when students were satisfied with the quality of their coursework (Braithwaite & Ahmed, 2005). Similarly, another study found that compliance is higher when the allocation of public goods across taxpayers reflects their contribution to these public goods (Alm et al., 2012). An individual's belief that an authority or institution acts appropriately, reasonably, and fairly has also been found to increase individuals' sense of obligation towards those authorities (Tyler, 2006).

Tax morale is also affected by a taxpayers' moral conscience, their religious beliefs, and their emotions. For example, trust in the government and religiosity have been found to have a positive effect on tax morale (Torgler, 2003, 2007). Similarly, religious taxpayers tend to be more compliant because they are more likely to experience feelings of guilt, shame, and embarrassment if they violate the law (Grasmick et al., 1991). Taxpayers who anticipate or experience feelings of guilt, humiliation, and embarrassment have generally been found to be more likely to comply (Ahmed, 2004). More broadly, feelings of guilt, regret, or shame might amplify the monetary consequences that taxpayers face when their cheating has been detected (King & Sheffrin, 2002). For example, taxpayers might fear social stigmatization if their evasion is detected (Orviska & Hudson, 2003). Conversely, tax evasion is more likely among taxpayers who do not anticipate feelings of guilt and shame when deciding to evade on their tax return (Erard & Feinstein, 1994; Andreoni et al., 1998). Tax evaders might also use strategies to avoid shame (e.g., by pretending that they did nothing wrong or by thinking about justification and excuses in advance), or they might attribute the causes of their wrongdoing externally (e.g., by arguing that either the complexity of the tax system or the incompetence of the tax administration is to blame for their noncompliance).

As a result of this research, shaming noncompliers has been proposed as a regulatory mechanism (Ahmed & Braithwaite, 2004; Ahmed, 2004). Tax agencies might induce feelings of shame in noncompliant taxpayers in order to increase the costs of evasion and to strengthen tax morale. Several studies have investigated how the public shaming of evaders affects compliance (Bosco & Mittone, 1997; Coricelli et al., 2014; Casal & Mittone, 2016; Alm et al., 2017). Overall, these studies find mixed evidence for the effectiveness of shaming. However, emotions matter in shaping compliance. For example, Enachescu et al. (2019) find that dealing with tax issues, filing returns, and interacting with authorities are all related to emotions, and negative emotions are correlated with taxpayers' intention not to comply. Relatedly, Olson et al. (2018) find that the tax agency's approach to tax administration (highlighting either its enforcement capacity or mutual trust or both) induces emotions in taxpayers and that these emotions shape the willingness to comply, with the implication that administrative policies that induce negative emotions can potentially undermine tax morale.

In sum, prior research shows convincingly that tax morale is an important determinant of tax compliance. It is also an indicator of the moral legitimacy of the tax system in general and the tax agency in particular. In the next section we discuss the effect of enforcement on tax morale.

Enforcement and tax morale

Several studies suggest that enforcement can have either positive or negative effects on compliance. While different explanations for this somewhat unintuitive and counter-deterrent effect of enforcement have been proposed in the literature, the underlying mechanism remains unclear. The effect of enforcement on tax morale is outside the scope of standard economic theory on tax evasion. Yet, there is some indication from other disciplines that enforcement can harm a taxpayer's personal norms and thus undermine the belief that paying taxes is the right thing to do.

Prior work suggests that the general as well as the specific deterrence effect of enforcement can be negative, suggesting that more enforcement may in fact lead to less compliance among some taxpayers and in some settings. For example, Mendoza et al. (2017) use country-level data on enforcement levels and tax evasion, and they find a U-shaped relationship between enforcement levels and tax evasion; that is, they find that noncompliance is relatively prevalent in countries with very low or very high enforcement levels, while non-compliance is less prevalent in countries with moderate enforcement levels. They attribute this result to a potential breach in the "psychological contract" between taxpayers and tax agencies (Feld & Frey, 2007), in which overly frequent audits signal to taxpayers that the tax agency does not trust them, which in turn reduces taxpayers' trust in the authorities and their willingness to comply (Kichler et al., 2008). Mendoza et al. (2017) conclude that taxpayers perceive very high enforcement levels as excessive and that this perception undermines their willingness to comply. In more recent work, Best et al. (2021) use a national program of randomized audits for the entire population of value added tax (VAT) filers in Pakistan, and they find that the audits do not deter future cheating, largely because the audits seem to focus on checking technical violations of the tax laws rather than on deterring evasion.

Moreover, other research finds that the experience of enforcement can have a negative effect on the post-audit tax compliance of audited taxpayers, suggesting the specific deterrent effect of tax audits can be negative (Gemmell & Ratto, 2012; DeBacker et al. 2018; Beer et al. 2020). These studies find that some taxpayers decrease their compliance after experiencing an audit, a phenomenon typically referred to as the "bomb-crater effect" (Guala & Mittone, 2005; Mittone, 2006). Several explanations have been suggested for these results, but the underlying mechanisms remain unclear (Kirchler, 2007; Alm, 2019; Beer et al., 2020). For example, some studies find that fines for past noncompliance might not be a strong deterrent of future noncompliance because fines are typically based on the evaded amount, rather than the income of the evader. Muehlbacher et al. (2007) suggests that basing the fines for noncompliance on the income of the evader increases compliance. Similarly, Muehlbacher and Sabitzer (2021) provide some evidence that taxpayers find such an income-based penalty scheme fairer than a penalty scheme that is based on the evaded amount only. Another explanation for the negative effect of enforcement on tax compliance is that audits might differ in their effectiveness, or the share of noncompliance that the agency detects during an audit. A poorly conducted tax audit that fails to assess a taxpayer's true tax liability might signal to the taxpayer that the tax agency is unable to administer the tax system effectively. When taxpayers conclude that the tax system does not work well, such an experience might affect fairness perceptions and undermine tax morale. Moreover, an ineffective audit (e.g., an audit that fails to detect undeclared income) might stimulate a taxpayer's willingness to take risks; that is, the taxpayer might infer that the agency is unable to discover cheating and thus the taxpayer will underreport his or her income in subsequent years (Andreoni et al., 1998). Indeed, a recent laboratory study finds that ineffective audits reduce post-audit compliance, while audits that detect all noncompliance increase post-audit tax compliance (Kasper & Alm, 2021a).

There are several alternative explanations for the decline in post-audit tax compliance. Audited taxpayers might misperceive the probability of future audits in laboratory settings and underestimate the risk of future audits (Mittone et al., 2017). Taxpayers might also be eager to make up for the losses they have incurred as a result of the audit (Andreoni et al., 1998; Maciejovsky et al., 2007). However, it remains unclear whether the perceived risk of future examinations is affected by the audit outcome or whether the tendency to make up for past losses pertains to individuals who have been found to be noncompliant. For instance, some studies find that individuals who were found to be compliant also report less income after experiencing an audit, suggesting that loss repair is not a sufficient explanation for the decline in reported income after an audit (Kastlunger et al., 2009; McKee et al., 2018; Bernasconi and Bernhofer, 2020). A recent study suggests that audited taxpayers who have been found to be compliant would have reduced their subsequent compliance irrespective of the audit outcome (Kasper & Alm, 2021b).

Another explanation for the negative effect of enforcement on compliance is that tax audits have different effects on different types of taxpayers (Erard & Feinstein, 1994; Torgler, 2003; Braithwaite, 2009). While some taxpayers are motivated entirely by the expected value of the evasion gamble, others comply regardless of any incentive to cheat (Braithwaite, 2003). Consequently, the decline in post-audit compliance might result from honest taxpayers who are less likely to comply after experiencing an audit. Those taxpayers perceive the audit as a breach of trust, find the audit unfair, or experience negative emotions. This experience might undermine tax morale and reduce taxpayers' propensity to comply in the future (Frey, 1997; Lederman, 2018; Hu & Ben-Ner, 2020). Overall, these issues remain unresolved.

In sum, several studies find that tax enforcement can lead to opposite than intended effects, such that high enforcement levels may reduce their propensity to comply, regardless of the specific mechanism by which this may operate. More broadly, these studies suggest that enforcement threat along with the experience of enforcement can undermine tax morale and thus reduce taxpayers' willingness to comply. However, these studies do not explicitly investigate how the experience of enforcement affects taxpayers' attitudes towards paying taxes in general and their willingness to comply in particular.

To better understand the effect of enforcement on taxpayers' attitudes, perceptions, and emotions, the Taxpayer Advocate Service of the U.S. Internal Revenue Service (IRS) conducted a large-scale survey study of audited and unaudited U.S. taxpayers, subsequently analyzed by Beer et al. (2018) and Erard et al. (2019). The survey comprised a representative sample of self-employed U.S. taxpayers, in which one half of the sample had recently experienced a tax audit and the other half had not. The comparison of survey responses between these two groups allowed a direct assessment of the effect of enforcement on taxpayers' attitudes, perceptions, and emotions. The survey also investigated the effect of different audit types (face-to-face audits either in the field or in the office and correspondence audits) and the effect of different audit outcomes (a tax refund, an additional tax assessment, or no adjustment).

As discussed in detail especially by Erard et al. (2019), the survey responses of audited and unaudited taxpayers provided mixed evidence for the effect of enforcement on tax morale. For example, taxpayers who had recently experienced an audit perceived their audit as more transparent, respectful, and appropriate in its outcomes than unaudited taxpayers who were asked to imagine what experiencing an audit would be like. This result indicates that the experienced fairness in the enforcement process exceeded the expected fairness of the enforcement process. Conversely, the survey also revealed that the audit experience might have a negative effect on tax morale. In particular, audited taxpayers had lower levels of trust in the IRS, and they were also more likely to indicate negative emotions towards the IRS than unaudited taxpayers; audited taxpayers were also more likely to agree with the statement that taxes are taken away from taxpayers rather than being a contribution to society. However, the general attitudes towards paying taxes did not differ between audited and unaudited taxpayers.

Moreover, Erard et al. (2019) investigated the effect of different audit types as well as the effect of different audit outcomes on tax morale. Overall, they found that audit recollection was poor among taxpayers who experienced a correspondence audit, with less than half of the taxpayers who experienced a correspondence audit over the past five years correctly recalling this event. In contrast, the vast majority of the taxpayers who experienced a field or office audit recalled being audited. These findings suggest that correspondence audits might not be perceived as actual audits. Hence, the deterrence effect of correspondence audits might be limited. Moreover, they found that taxpayers who experienced a correspondence audit perceived the audit experience to be substantially less fair than taxpayers who experienced a field or an office audit. This might indicate that in contrast to correspondence audits, face-to-face audits that allow direct interactions with the authorities give space for explanations and clarifications that regard tax issues and interpretations of law.

Finally, Erard et al. (2019) investigated the relation between the audit outcome and taxpayers' attitudes, perceptions, and emotions. As expected, taxpayers who received an additional tax assessment as a result of their audit reported more negative attitudes and emotions than taxpayers who received a refund or no adjustment, indicating lower levels of procedural, informational, interpersonal, and distributive justice in the audit process than the other groups. Those taxpayers also reported relatively low levels of trust in the IRS and relatively high levels of negative emotions, such as anger, towards the IRS.

In sum, these results suggest that the enforcement experience can indeed reduce the tax morale of audited taxpayers. While the deterrent effect of correspondence audits appears to be limited, correspondence audits seem more likely to negatively affect tax morale. This raises the question whether the increasing reliance on non-personal communications in tax administrations has a positive effect on compliance. Moreover, these studies suggest that enforcement reduces tax morale particularly among taxpayers who were determined to be noncompliant.

We discuss how tax agencies can use the insights obtained from all of this research to alleviate the negative effect of enforcement on tax morale in the final section of this chapter.

Summary and conclusion

A large body of literature investigates the effect of enforcement on tax compliance. Counterintuitively, many studies find that enforcement can actually reduce, rather than increase, compliance among taxpayers. While the drivers of these behaviors still remain uncertain, we believe that there is emerging evidence that these surprising effects of enforcement work largely through the ways in which they influence taxpayers' tax morale and their ethics. We argue that deterrence per se is not sufficient to establish high levels of compliance and that enforcement (if ineffective or if perceived as unfair or excessive) can actually reduce compliance. In other words, we argue that there is evidence – suggestive if not yet conclusive – that notions of tax morale and ethics can be changed by these experiences.

Indeed, we present recent research evidence that audit frequency, audit effectiveness, audit type, and audit outcome affect and, in some cases, reduce tax morale. Taxpayers reflect on the behavior of the tax agency along several dimension: they try to make sense of the actions of the tax agency, they form opinions about whether or not these actions are justified, they search for opportunities to blame others (such as the tax agent) or circumstances (such as the complexity of the tax system) for their wrongdoing, and they experience emotions (such as anger or fear) when experiencing enforcement. If taxpayers perceive enforcement as excessive, unfair, or unjustified, they may develop a desire to make up for this seemingly unfair treatment and get back at the tax agency. In some instances, they might change their attitudes towards paying taxes more fundamentally, and move up the compliance pyramid from commitment to resistance and even to disengagement (Braithwaite, 2003). It is through these channels that enforcement can reduce tax morale and decrease compliance.

What can tax administrations do to increase the deterrent effect of enforcement, strengthen tax morale, and mitigate these negative responses?

First and foremost, tax agencies should acknowledge that taxpayers are different and that these differences should be reflected in their approach to tax administration. Indeed, as emphasized by Gould (1996) in the vastly different context of evolution, it is quite misleading to represent a complex system by a single representative or average agent. Instead, he argues that most systems have incredible diversity – a "full house" of individual behaviors – and the proper understanding of these systems requires recognition of this fundamental truth. This lesson seems especially appropriate for tax compliance, where taxpayers exhibit remarkable diversity in their behavior. Most taxpayer comply voluntarily, largely because they are convinced that paying taxes is the right thing to do. Even so, there are also individuals who always cheat, some who behave as predicted by economic models by maximizing the expected utility of the tax evasion gamble, others who overweight low probabilities of audit, some who dismiss entirely these probabilities, still others who are at times cooperative and at other times free-riders, and many who seem motivated by such things as social norms, as captured broadly in tax morale. This "full house" of taxpayer types requires a corresponding "full house" of administrative policies (Alm, 2019).

Accordingly, tax agencies should aim to strengthen tax morale. Specifically, tax agencies should facilitate compliance by making it easy for taxpayers to access information and taxpayer services. This is particularly relevant in light of digital transformation in tax administrations. As many taxpayers do not have access to digital services or are unable to fully utilize these services, telephone support and face-to-face interactions should remain a communication channel for taxpayers who rely on them. Moreover, tax agencies should aim to establish a trustworthy and synergistic tax climate in which taxpayers are considered as business partners, rather than potential cheaters. However, it must still be recognized and acknowledged that some taxpayers only comply when they sense that cheating does not pay. Tax agencies should have the funds and the legal instruments to prosecute these taxpayers and enforce compliance. Again, tax agencies need a full house of policies to address the full house of behavior.

Second, enforcement activities should be well targeted towards noncompliant taxpayers and not to the population of taxpayers in general. Effective, well targeted tax enforcement signals the tax agency's capacity to protect the compliant majority from being exploited by free-riders. Conversely, enforcement that is poorly targeted at compliant individuals might be perceived as signal of distrust, evoke fear and anger rather than feelings of protection and security, affect randomly audited taxpayers' subjective representations of authorities and the tax system, alter their ethics and tax morale, and consequently undermine their willingness to comply. Tax agencies should also increase the effectiveness of their audits. Tax audits should be conducted thoroughly in order to reflect the tax agency's ability to administer the tax system effectively. Modern technologies may facilitate compliance on the taxpayers' side and effective control on the authorities' side, thereby increasing the probability of detecting evaders, prosecuting them, and thus protecting the compliant majority from exploitation by free-riders.

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