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Psychological Tax Contract**

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# **Tax Evasion, Tax Amnesties and the Psychological Tax Contract**

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## **Abstract**

Tax compliance has been studied in traditional public economics by heavily relying on deterrence as the most important compliance-increasing factor. This model of tax evasion is however challenged by inconclusive empirical evidence also pointing to the importance of tax morale as the individual's intrinsic motivation to honestly pay taxes. Tax morale is, however, also endogenous and depends on an interaction of individual taxpayers and the state that could be perceived as a fiscal exchange in a broader sense. Such a fiscal exchange involves the provision of public services for the tax payments received, but it goes beyond purely monetary rewards as it is also affected by the way political decisions are made (procedural fairness) and by the way tax authorities treat taxpayers in tax audits (interactional fairness). The relationship between the taxpayers and the taxing state can thus be understood as an implicit or "psychological tax contract", under which the government must balance strategies of deterrence with those of responsive regulation. In this paper, we extend the analytics of a "psychological tax contract" by considering the impact of tax amnesties on the contract.

Keywords: Tax Evasion, Tax Amnesties, Psychological Tax Contract.

JEL Classification: H26, H73, D78.

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## 1 Introduction

Tax compliance has many facets. The tax evasion by wealthy people not declaring their capital incomes received in foreign tax heavens may nurture particular prejudices of what is involved, but is far from providing a comprehensive picture. Tax non-compliance also comprises the taxes un(der)reported when individuals work in the shadow economy; or tax avoidance by multinational firms becoming illegal when a (financial) court reaches a final verdict on particular tax saving schemes; or the sophisticated trading schemes which allow evading commodity taxes; or donations by family members to their supposed heirs to evade inheritance taxes; and so on. Tax compliance is moreover related to the broader concept of tax morale which also includes the attitudes of honest taxpayers, who have never underreported their true incomes, to potential tax non-compliance of their dishonest fellow citizens. Is cheating on the tax code partly accepted as a minor disobedience, and which part of it is? Is tax non-compliance seen as undermining the functioning of a state in general? Or is it even accepted as a kind of popular gaming activity in which the state sometimes loses, sometimes wins? All these issues matter for tax compliance.

In spite of the thus implied need to cope with tax non-compliance in a differentiated way, economic policy reactions to this complex phenomenon do not infrequently appear to be unidimensionally focused on deterrence measures or incentives in general. For example in Germany, just to give a flavor, the recent efforts have comprised

- increases in deterrence, like, e.g., the so called “*Black Activities’ Act*” or more exactly the “*Law to intensify the fight against black activities and accompanying tax evasion*” (SchwarzArbG, Bundesrats-Drucksache 155/04a) in 2004 aiming at both raising fines and the intensity of control;

- measures to coordinate capital and corporate income taxation in the EU, e.g., the European Savings Directive in 2005, which implements a (partial) system of information exchange, or the still ongoing negotiations about a Common Consolidated Corporate Income Tax Base;
- several measures to intensify auditing by increasing the transparency of monetary transactions between individual bank accounts that in sum almost abolish the German bank secrecy laws;
- tax rate reductions in the case of personal and corporate income taxation in 2000 and, in particular, as of 2008 onwards, including a new source tax on capital income and capital gains to be implemented in 2009;
- a tax amnesty in 2003.

Overall, this will have amounted to a decade of tax policy changes targeted to increase tax compliance or, as a former German finance minister put it, to fight tax evasion from cleansing services in households to the international capital markets.

Such policy efforts are supported by the traditional economic approach which has relied heavily on deterrence as the most important determinant of tax compliance (Allingham & Sandmo 1972, Sandmo 2006). Modern research from different fields, including economics and psychology, raises some doubts as to the validity of this approach, however. In a careful interdisciplinary approach, Kirchler (2007, p. 197) summarizes the findings by concluding that tax morale, and subsequently tax compliance, depends on tax knowledge, attitudes, norms, perceived opportunity, fairness considerations and motivational postures.<sup>1</sup> Tax morale would thus imply an intrinsic motivation to comply with the tax laws. Deterrence contributes to some of

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1. See also the Special Issue on Responsive Regulation and Taxation, *Law and Policy* 29 (1), 2007.

these factors, but does not always do so in the same qualitative fashion. It may on the one hand have the standard effect expected by the traditional economic approach that the expected fine serves as a price on tax non-compliance and thus negatively affects it (Gneezy & Rustichini 2000). On the other hand, it may as well be that the intrinsic motivation to pay taxes is crowded out by the state's intervention into individuals' privacy (Frey 1997, 1997a).

Following the much broader research strategy following from his interdisciplinary approach, Kirchler's (2007) suggestion for tax compliance research is the shift from a perspective of compliance enforced by authorities' power ("cops and robbers approach", p. 188) to voluntary compliance driven by trust in authorities ("service and client approach", p. 188). He shapes this suggestion by a slippery slope model according to which deterrence and trust as two equally valid ways of achieving compliance could dynamically interact with each other. This interaction would finally evolve to a system of responsive regulation. These conclusions and suggestions are rather cautious and leave much room for continuous reinterpretations. A slippery slope is also characterized by a situation of shaky ground.

In contrast to such an evolutionary perspective with the aim of providing firmer ground, Feld and Frey (2007) analyze tax compliance following the approach of a psychological tax contract. Instead of referring to different experiences, histories or cultures, however vague such issues may be, in different countries, they start from the Wicksellian (1896) perspective of voluntary exchange between citizens that implies a contractual justification of the state. Individuals subject themselves to the coercion inherent in collective action because the underlying constitutional exchange is in their well-understood long-term interest (Buchanan 1987). With respect to fiscal issues, the psychological tax contract pushes the idea of taxation as fiscal exchange (Buchanan 1976) beyond narrow direct incentives, like deterrence, but also beyond narrow monetary benefits as they could be provided by public goods and services following the benefit principle of taxation. For such a contract to be upheld, loyalties and emotional ties

must be considered additionally. These bonds between taxpayers and the state shape individual tax morale and thus positively affect tax compliance. Incentives are an important ingredient of the psychological tax contract, but their role is assessed in a much more differentiated fashion as in the traditional economic approach. More importantly, the psychological tax contract is influenced by government policy, tax authorities' behavior and state institutions.

In this paper, we push the analytics of a psychological tax contract a bit further. In *Section 2*, the theoretical basis of the psychological tax contract is provided by discussing the interactions between incentives and the intrinsic motivation to pay taxes. Positive (rewards) or negative incentives (deterrence) play a role, but it cannot be taken for granted that they induce tax compliance because they may also crowd out tax morale. Thoughts on the impact of deterrence and rewards on tax compliance highlight the importance of a differentiated approach.

A contractual relationship implies duties and rights for each contract partner. This is looked at from an exchange perspective (*Section 3*) according to which the government should provide public services to citizens in exchange for their tax payments. If the benefit principle of taxation that implies a fiscal equivalence between public goods and tax prices is violated by setting those prices too high, citizens think they have a justification for evading taxes. However, citizens may perceive their tax payments as contributions to the '*bonum commune*' such that they are willing to honestly declare their income even if they do not receive a full public good equivalent to their tax payments. Income redistribution is the more accepted by affluent citizens the more the political process is perceived to be fair and the more policy outcomes are legitimate: The psychological tax contract has elements of gain (or distributive justice) and participation (or procedural justice).

The contractual relationship has additional implications at the procedural level (*Section 4*): the way the tax office treats taxpayers in auditing processes plays a role. As Frey & Feld (2002) argue, the psychological tax contract presupposes that taxpayers and the tax authority treat

each other like partners, i.e. with mutual respect and honesty. If tax administrations instead treat taxpayers as inferiors in a hierarchical relationship, the psychological tax contract is violated and citizens have good reason not to stick to their part of the contract and evade taxes. The psychological tax contract has thus also elements of respect (or interactional justice). The notion of a psychological tax contract also helps to highlight how difficult a policy of tax amnesties will be to uphold tax compliance (*Section 5*).

In *Section 6*, we draw some conclusions as to the policy implications of such a contractual view of tax compliance. It implies that simple policy proposals are inadequate to shape the psychological tax contract successfully. The right mixture of incentives and a respectful treatment of taxpayers by tax officials needs to be found.

## **2 The Psychological Tax Contract**

Nobody likes paying taxes, not least because it involves a public good and there are incentives to free ride. Therefore, incentives are needed to enforce taxation. This is the central insight of Allingham and Sandmo's (1972) deterrence approach to tax evasion. However, several scholars have established that selfish individuals would be rational not to pay taxes, because the probability of being detected and the size of the fines in many countries are so low that it is advantageous to evade.<sup>2</sup> Tax payment is taken to be a 'quasi-voluntary' act (see Levi 1988) and the tax authority must acknowledge that external interventions in the form of rewards or

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2. See Alm, McClelland & Schulze (1992), Graetz & Wilde (1985), Skinner & Slemrod (1985) or Pommerehne & Frey (1992) who conclude that the risk aversion that is needed in order to raise compatibility with actual compliance rates is not supported by evidence. In a recent paper, Slemrod (2007) has questioned such an interpretation of the evidence by arguing that the way tax authorities collect information on taxpayer compliance matters such that the probability of detection increases considerably for large parts of the taxpaying population. His example draws on taxation of labor at source, but neglects that many workers do not need to underreport their true income earned in the official part of the economy, but could conduct black activities.

sanctions may crowd out that intrinsic motivation to pay taxes. The idea of intrinsic motivation is largely attached to psychology. A group of cognitive social psychologists have identified that, under particular conditions, monetary (external) rewards undermine intrinsic motivation.<sup>3</sup> Giving of rewards for undertaking an activity has indirect negative consequences as rewards lead to the expectation of future rewards such that desired behavior is undertaken only if rewards are provided. Frey (1997) generalizes this basic idea in three ways:

- (a) All types of external interventions may negatively affect intrinsic motivation, i.e. not only offering rewards but also issuing commands, imposing rules and regulations as well as punishments. Thus, *deterrence* imposed by the tax authority, may undermine individuals' intrinsic willingness to conform to tax laws.
- (b) The intrinsic motivation affected by external intervention is broadly conceived. It comprises actions undertaken for their own sake, i.e. without expectation of external reward, as well as *internalized norm guided behavior*. The latter is the relevant concept as far as taxpaying is concerned.
- (c) External interventions undermine intrinsic motivation when they are perceived to be intrusive by the individuals concerned ('crowding out effect'), and they maintain or raise intrinsic motivation when they are perceived to be supportive. The underlying psychological processes depend on how self-determination and self-esteem are affected (Deci & Ryan 1985; Deci & Flaste 1995). Tax audits as intrusion by tax authorities can undermine tax morale more strongly if the taxpayers' sense of self-determination is high.

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3. Headed by Deci (1971). Extensive surveys are given e.g. in Pittman & Heller (1987), and Lane (1991). The effect is also known as '*The Hidden Cost of Reward*' (see Lepper & Greene 1978). For meta-analyses see Deci, Koestner & Ryan (1999) and Cameron, Banko & Pierce (2001). That external interventions may crowd out intrinsic motivation is introduced into economics as '*Crowding Theory*' (Frey 1997; Le Grand 2003) and is supported by much empirical evidence (Frey & Jegen 2001).

Tax officials are assumed to be aware of the effects on taxpayers' behavior suggested by crowding theory. They know that a disrespectful treatment of taxpayers undermines their tax morale and therewith increases the cost of raising taxes. Tax authorities will only behave in a respectful way towards taxpayers when there is a substantial extent of tax morale to begin with. Tax officials are at the same time well aware that tax payments do not solely depend on tax morale but that extrinsic incentives play a major role. In particular, incentives are used to prevent taxpayers with low or lacking tax morale from exploiting the more honest taxpayers and to escape paying their due share. A combination of respectful treatment and incentives is possible and widely practiced. The sole reliance on incentives, as suggested by a large part of the tax compliance literature based on subjective expected utility maximization, represents a special case which only applies under restrictive conditions. Such a special case occurs when the tax officials are convinced that individuals' tax morale is low or does not exist at all. In general, however, it is optimal to simultaneously use both respectful treatment as well as incentives. The higher the initial level of tax morale, and the stronger the crowding effect, the less weight is put on incentives, and the more respectfully taxpayers are treated.

This relationship between taxpayers and tax authorities can be modeled as an implicit or relational contract (Akerlof 1982) which involves strong emotional ties and loyalties. Social psychologists (Schein 1965; Rousseau & McLean Parks 1993) have been using this concept for a long time, calling it a 'psychological' contract to set it clearly apart from formal contracts, which are obeyed because the parties respond to the explicit and material sanctions previously agreed upon. Osterloh & Frey (2000), e.g., use psychological contracts to successfully analyze the organization of firms. They could also be used in tax compliance analysis suggesting that incentives and respectful treatment are important determinants of tax compliance.

In the psychological tax contract, punishment still plays a role in order to provide deterrence. But the satisfaction of taxpayers with what they get from the other contract party, i.e. the gov-

ernment, mainly influences their tax morale. Taxpayers' reward from that contract must be understood in a broad sense going beyond pure exchanges of goods and services for the payment of a tax price. In addition to such direct exchange components, the fairness of the procedures leading to particular political outcomes as well as the way the government and the taxpayers treat each other are part of the contractual relationship. A genuine reward is therefore obtained only if taxpayers as citizens have an inclusive, respectful relationship with the community. Both sides of the contract perceive each other as contract partners and treat each other with mutual respect. As deterrence and tax morale interact, it would be counterproductive to solely rely on punishment or monetary (non-authentic) rewards because tax morale can be undermined. A dynamic relationship results in which deterrence, monetary rewards, fiscal exchange, but also decision-making procedures and the treatment of taxpayers play a role.

The contractual metaphor has many advantages over traditional theoretical approaches. It first underlines that paying taxes is a quasi-voluntary act. Each party has to agree to the contents of the contract. In practice, it is seldom the case that each public good is individually contracted with each taxpayer for a certain tax price. However, a steady reduction in tax compliance need not only be interpreted as a violation of the law, but also as taxpayers' discontent with what they receive for their taxes. Second the contractual approach emphasizes the role of fair procedures decided upon at a constitutional stage. Tyler (1990) argues that people comply with the law in general if they perceive the process as fair that leads to this law. Most obviously, it will be difficult to think of a psychological tax contract in autocratic regimes. The inclusiveness of political decision-making could however also be very different in democratic regimes depending on the extent of citizens' involvement in political decision-making. This second advantage of the contractual metaphor stems from its potential to include notions of procedural fairness almost by construction. Third, the way people are treated by the tax authorities affects cooperation levels. Again the analogy to private contracts is useful. If you can purchase a product from two different suppliers, would you choose that who is more friendly and

respectfully treating his customers? For sure, if the price differential is not too high. In a similar fashion, the way the tax office treats taxpayers plays a role.

At this procedural level, respectful treatment can be split into two different components. First, the procedures used by auditors in their contact with taxpayers are to be transparent and clear. In the case of arbitrary procedures, taxpayers feel helpless and get the impression that they are not taken seriously. Such behavior reduces their perception of being obliged to pay taxes. Second, respectful treatment has a direct personal component in the sense of how the personality of taxpayers is respected by tax officials. If they treat taxpayers as partners in a psychological tax contract, instead of inferiors in a hierarchical relationship, taxpayers have incentives to pay taxes honestly. In addition, respectful treatment of taxpayers enforces the effects of emotions on compliance behavior. Grasmick & Bursik (1990) show for example that shame affects tax compliance. Makkai & Braithwaite (1994) report similar evidence on the impact of avoidance of humiliation on compliance with nursing home regulation.

Two opposite cases of treating taxpayers can be distinguished: (1) a respectful treatment supporting, and possibly raising, tax morale; (2) an authoritarian treatment undermining tax morale. The tax officials can choose between these extremes in many different ways. For instance, when they detect an error in the tax declaration, they can suspect an intent to cheat, and impose legal sanctions. Alternatively, the tax officials may give the taxpayers the benefit of a doubt and inquire about the reason for the error. If the taxpayer in question indeed did not intend to cheat but simply made a mistake, he or she will most likely be offended by the disrespectful treatment of the tax authority. The feeling of being controlled in a negative way, and being suspected of tax cheating, tends to crowd out the intrinsic motivation to act as an honorable taxpayer and, as a consequence, tax morale will fall. In contrast, if the tax official makes an effort to locate the reason for the error by contacting the taxpayer in a friendly way, the taxpayer will appreciate this respectful treatment and tax morale will be upheld.

## **2.1 The Impact of Deterrence on Tax Compliance**

Given the requirements of a psychological tax contract, what role does deterrence play? According to the surveys by Andreoni, Erard & Feinstein (1998) and Slemrod & Yitzhaki (2002), an overwhelming majority of theoretical studies predicts a positive impact of deterrence on tax evasion. The higher the fines, the lower is tax evasion – *ceteris paribus*; the higher is the intensity of control, the lower is tax evasion – *ceteris paribus*. However, the empirical evidence looks less convincing. For example, Dubin, Graetz & Wilde (1987), Dubin & Wilde (1988), Beron, Tauchen & Witte (1992), Slemrod, Blumenthal & Christian (2001), Alm & McKee (2006) and Bergman & Nevarez (2006) find a negative impact of a higher probability of detection on tax compliance at least for some groups of taxpayers. While Schwartz & Orleans (1967), Friedland, Maital & Rutenberg (1978), Klepper & Nagin (1989), De Juan, Lasheras & Mayo (1994), Alm, Sanchez & De Juan (1995), Blackwell (2002) report a positive impact of fines on tax compliance, Spicer & Lundstedt (1976), Friedland (1982), Elffers, Weigel & Hessing (1987) and Varma & Doob (1998) present ambiguous evidence. Scholz & Lubell (2001) even find a crowding out of tax compliance when penalties are introduced. Feld & Frey (2002) provide support for the ambiguous impact of deterrence on tax compliance. For a panel of Swiss cantons, they find that a higher intensity of control increases tax evasion while fines and penalties reduce tax evasion. Martinez-Vazquez and Rider (2005) report evidence for the U.S. that enforcement efforts affect the mode of tax evasion targeted by these efforts negatively, but the untargeted mode positively. While they find an overall positive effect of enforcement on tax compliance, it remains generally open whether the unintended side effect on the untargeted mode over-compensates the intended effect.

This mixed evidence can occur for many different reasons starting from measurements errors in the empirical analysis, to a social sanctions approach of deterrence (Ekland-Olson, Lieb and Zurcher 1984) and the impact of personal and social norms as moderators of deterrence

(Wenzel 2004). It can however be at least as convincingly explained by crowding theory. Higher control intensities increase deterrence and thus tax compliance on the one hand, but may be perceived as intrusive by taxpayers and thus reduce tax compliance on the other hand (Scholz and Pinney 1995; Kirchler 1999). Feld and Frey (2002) provide evidence that fines and penalties are part of a non-linear punishment schedule that allows for low levels of fines in the case of minor offenses against the tax code, even a standing tax amnesty in the case of self-denunciation, in order to reduce taxpayers perception of intrusiveness, but requires high penalties in cases of tax fraud or major convictions in order to make clear that the psychological tax contract is at stake. Put differently, nobody is perfect, and to cheat a little bit on taxes is a common and minor human weakness, and should be considered as such, while basic violations of the tax code undermine the basic contractual relationship between citizens and the state and must therefore be punished more heavily. Minor and major offenses could thereby be distinguished with respect to the amount evaded, but also to procedural categories, for example by differentiating between active tax fraud by manipulation of the balance sheet and passive tax evasion when taxpayers forget to report particular income components.

Deterrence has thus two different aspects. On the one hand, in order to keep up a psychological tax contract between the tax office and the taxpayers, honest taxpayers must be confident that they are not exploited by dishonest tax cheaters. Thus, deterrence for major violations of the tax code reduces tax evasion. On the other hand, each taxpayer may make a mistake, so that minor offenses can be penalized less without undermining the psychological tax contract. A non-linear punishment schedule with low fines for minor tax evasion and high penalties for tax fraud, will serve the purpose of shaping tax morale. All in all, the evidence suggests that an exclusive reliance on deterrence is not a reasonable strategy to increase tax compliance.

## 2.2 Rewarding Taxpayers

In contrast to the standard model of tax evasion which raises the relative cost of *not paying* taxes, rewards raise the benefits of *paying* taxes. A reward given to taxpayers for correctly fulfilling their duties changes the relative prices in favor of paying taxes, and against evading them (Falkinger & Walther 1991). For this result to obtain, two conditions must be met:

- (1) The income effect induced by the higher wealth position must not work in the opposite direction. But this is unlikely if the reward is small compared to the tax liability so that the income effect also tends to be small. Moreover, there is little reason to expect that higher wealth should induce more, rather than less, tax evasion.
- (2) The reward may induce strategic behavior by the taxpayers if it depends on the reduction of evasive behavior. In that case it may be rational to first increase tax evasion and thereafter reduce it in order to benefit from the rewards offered. As the rewards considered here depend on *being* a “good” taxpayer, strategic behavior is not a rational option.

It is crucial to consider effects of rewards on behavior going beyond those analyzed by standard theory. From the perspective of crowding theory, receiving certain types of rewards may undermine the intrinsic motivation to pay taxes. The more rewards are perceived as an acknowledgment for being a good taxpayer, the more they are perceived as supporting and tend to bolster and raise tax morale quite in contrast to deterrence. This motivational effect then works in the same direction as the relative price effect, and strengthens the attractiveness of giving rewards to “good” taxpayers. In the case of the normally applied punishment for failing to pay the taxes due, the relative price effect and the motivational crowding-out effect work in opposite directions. The *way* rewards are handed out to “good” taxpayers is thus essential for its effects on taxpayer behavior.

The reward may take the form of a *direct monetary* payment. It may be proportional to the size of the tax payment (i.e. a percentage rebate), or in the other extreme may take the same size for all “good” taxpayers. The relative price effect is larger in the first case, but this beneficial effect may easily be overcompensated by a crowding-out effect. A reward received in the same monetary dimension as the tax payments is likely to be discounted by the taxpayers as a “right”, and then does not positively influence tax morale. In contrast, a reward on purpose distinguished from the taxes due tends to be perceived as a sign of acknowledgment. If this is indeed the case, it is even better to give the reward in *non-monetary* form. To provide “good” taxpayers with better and less costly access to public services is likely to raise tax morale more strongly than money. Such a “gift” also emphasizes the exchange relationship between the taxpayer and the state based on reciprocity (Fehr, Gächter & Kirchsteiger 1997). There are many possibilities to reward “good” taxpayers in these terms. For instance, they can be offered free entry to museums, exhibitions and other cultural activities undertaken by the state. Or they can be given a reduction (say, 50%) on all public transport. Most taxpayers receiving a reward in these terms take it as a sign of appreciation rather than simply a reduction in taxes (which would quickly be taken as a matter of course).

It is well known from psychological research that punishment and rewards lead to different behavioral outcomes. Indeed, it appears to be common knowledge among psychologists that rewards lead to better outcomes than punishment. Already Skinner (1948, 1953) emphasized the importance of positive incentives. In the literature on social loafing (see Diehl & Stroebe 1987; Witte 1989), the impact of reward and punishment are emphasized and it is shown that rewards particularly help to solve the problem of “hiding in the crowd” (Davis 1969).

### **3 Tax Compliance and Social Exchange**

From the perspective of standard economic theory, a much more direct incentive for tax compliance than deterrence or rewards consists in the goods and services that the state provides to

citizens in exchange for their tax payments (Mackscheidt 1984, Smith and Stalans 1991). If the analogy to private contracts is considered, the goods or services purchased provide the foremost incentives to pay the price for these goods and services. The incentives from private law to stick to the duties fixed by the contract mainly serve as an insurance if the individuals' desire to get a product is insufficient or the conditions for a *do ut des* are unfavorable. Similarly, rewards in the form of gifts for loyal customers serve as a positive means to bind them. Because the state supposedly provides public goods, services and infrastructure, which are not necessarily traded in private markets, or redistributes income and wealth, the fiscal exchange relationship poses additional difficulties.

From the perspective of a psychological tax contract, respectful treatment occurs at two different levels of action, the fiscal exchange and the procedural level. The fiscal exchange between the state and its citizens requires that citizens' tax payments are met by public services provided by the government. According to the benefit principle of taxation, taxes are prices for certain public goods (Buchanan 1976). However, the benefit principle does not necessarily imply that income redistribution becomes impossible and only infrastructural goods as well as public consumption goods are provided by the state. Citizens may perceive their tax payments as contributions to the '*bonum commune*' such that they are willing to honestly declare their income even if they do not receive a full public good equivalent to their tax payments. Income redistribution is the more accepted by affluent citizens the more the political process is perceived to be fair and the more policy outcomes are legitimate.

### **3.1 Establishing Social Exchange between Citizens and the Government**

Empirically, the more governments follow the benefit principle of taxation and provide public services according to the preferences of taxpayers in exchange for a reasonable tax price, the more taxpayers indeed comply with the tax laws. Spicer & Lundstedt (1976), Porcano (1988), Alm, McClelland & Schulze (1992) and Alm, Jackson & McKee (1992, 1992a, 1993) present

experimental evidence that governments which stick to the principle of fiscal exchange achieve more tax compliance. Pommerehne, Hart & Frey (1994) use a simulation study design to analyze the impact of fiscal exchange on tax compliance. They show that the more the citizens' optimal choice of a public good and the actual provision level and quality deviate from each other, the higher is tax evasion. Tax compliance also increases with reductions in government waste. In the experimental papers, the proposed fiscal exchange relationship is based on the provision of a public good financed by taxes. Several authors have used this analogy to public good games in order to analyze additional variables that influence tax evasion (see e.g. Feld & Tyran 2002). According to the benefit principle of taxation such a restricted view of government action could be rationalized.

However, in real world settings the state undertakes many activities that cannot be subsumed under the heading of a public consumption good or public infrastructure. In particular, any kind of pure redistribution is not covered by such a design. Whenever redistribution of income is at stake, problems of tax evasion are however pertinent. There are only a few studies that consider the relationship between tax evasion and redistribution in a fiscal exchange setting. In their experiments, Güth & Mackscheidt (1985) chose a simple tax-transfer-scheme to come as close as possible to the principle of vertical equity, i.e. take from the rich and give it to the poor. They found that subjects had a compliance rate of 93 percent. Becker, Büchner & Slesking (1987) report however that evasion rises if taxpayers believe to lose from redistribution.

Obviously, the satisfaction with what the government provides in exchange for tax payments strongly depends on the experimental setting or, in the real world, on the environmental conditions. It appears that notions of fairness or justice shape the extent to which the fiscal exchange paradigm increases tax compliance in particular. Kinsey & Grasmick (1993) report evidence that horizontal equity plays a role. If an individual's tax burden is of about the same magnitude as that of comparable others, tax compliance increases (see also Spicer & Becker

1980; De Juan, Lasheras & Mayo 1994). Kinsey & Grasmick (1993) and Roberts & Hite (1994) report that vertical unfairness of the tax schedule (the progressivity of the income tax) increases tax evasion. This is in line with the results by Scott & Grasmick (1981) who report evidence that deterrence was more effective for taxpayers who perceived the tax system to be unfair. Moreover, Scholz & Lubell (1998) emphasize the importance of trust in government for tax compliance. In contrast to their definition (1998: 411), trust in government is more than a “rough measure of the net benefits from governing institutions”. It also involves the effectiveness of the government to conduct the policies and programs promised to citizens. In particular, trust in government can be eroded if government waste is high. Braithwaite (1998, 2003) underlines the delicate nature of a loss of trust when taxpayers are not confident that the tax authority is able to regain its trustworthiness. Ahmed & Braithwaite (2004) report empirical evidence on a significantly higher non-compliance among those that have lost hope, i.e. who believe that trustworthiness of the government is low.

### **3.2 Establishing Fiscal Exchange by Political Decision-Making Procedures**

The fiscal exchange relationship between taxpayers and the state therefore depends on the politico-economic framework within which the government acts. According to Alm, McClelland & Schulze (1999: 149), rational egoists should vote for the lowest control intensities and fines that are necessary to ensure compliance. However, the possibility for voters to vote directly on matters of content increases the legitimacy of policies and serves as an insurance against exaggerated government waste. Direct political participation particularly activates public spiritedness of taxpayers (Feld and Kirchgässner 2000).

In an experimental study, Feld & Tyran (2002) find that tax compliance is higher on average in an endogenous fine treatment in which subjects are allowed to approve or reject the proposal of a fine as compared to an exogenous fine treatment where the fine is imposed by the experimenter (see also Alm, McClelland & Schulze 1999). The main explanation why people

show a higher tax morale if they are allowed to vote on a fine is legitimacy. Not only do subjects who approve the fine in the endogenous fine treatment have a considerably higher tax compliance than subjects in the exogenous fine treatment. Compliance rates are higher if the fine is accepted than in the case the fine is rejected. Subjects who reject the proposal of the fine show a higher compliance rate than subjects in the exogenous fine treatment even if they know that the dominant strategy under the existence of the low fine is non-compliance. Finally, individuals who vote against the fine contribute effectively more if the fine is adopted than individuals voting for the fine contribute in the case the symbolic fine is rejected.

Field studies by Pommerehne & Weck-Hannemann (1996), Pommerehne & Frey (1992) and Frey (1997a) provide additional support for the experimental findings. Focusing on tax evasion in the Swiss cantons between 1965 and 1978, they find that the more direct democratic the political decision-making procedures of a canton are, the lower is tax evasion according to those studies. These results are replicated by Feld & Frey (2002) and Frey & Feld (2002) by extending the sample to the period 1985 to 1995. Torgler (2005) uses an alternative approach to study tax morale in the Swiss cantons by investigating two micro data sets, the World Value Survey and the International Survey Programme, that contain questions about tax morale of respondents. His results provide evidence that direct democracy shapes tax morale. According to his estimates, tax morale is significantly higher in direct democratic cantons. Distinguishing between different instruments of direct democracy, he finds that the fiscal referendum has the highest positive influence on tax morale. Moreover, tax morale of respondents is higher if they have a higher trust in government, or in the courts and the legal system. Since studies for the U.S. (Gerber 1999) and Switzerland (Pommerehne 1978) show that policies in direct democratic jurisdiction are more strongly in line with citizens' preferences, institutions of direct democracy can be seen as a means to establish a relationship of fiscal exchange between taxpayers and the government.

In addition, Torgler (2005) reports evidence that local autonomy as an indicator of fiscal federalism has a marginally significant positive impact on tax morale. Güth, Levati & Sausgruber (2005) find a stronger effect of fiscal decentralization on tax compliance in an experimental setting. Subjects show a higher tax morale if public goods are provided and financed regionally or locally because their taxes are spent on their own regional or local public goods. The fiscal equivalence of the theory of fiscal federalism then holds more strongly.

#### **4 The Treatment of Taxpayers**

The psychological tax contract is also supported by interactional justice, in particular a respectful treatment of taxpayers by tax authorities. In order to investigate the relationship between taxpayers and tax authorities, Feld and Frey (2002) have sent a survey to the tax authorities of the 26 Swiss cantons which asked detailed questions about the legal background of tax evasion, but also included questions on the treatment of taxpayers by tax authorities in day-to-day audits, in particular when a taxpayer is suspected of not declaring his or her true taxable income. According to this survey, the extent of *respectful treatment* of the taxpayers is captured by (1) Fully observing procedures based on formal and informal rules, i.e. what happens typically if a taxpayer does not declare taxable income at all (procedures, fines), if a tax declaration is mistakenly filled out or, in a second stage, if taxpayers do not react?; (2) Acknowledgment of individual citizens' rights and personality, i.e. what does the tax administration do if taxpayers declared taxable income by mistake too high? Are there attempts to find out whether taxpayers intentionally or mistakenly declare too low a taxable income? Are mistakes in the tax declaration to the advantage or to the disadvantage of *taxpayers*?

The way taxpayers are treated by tax authorities reveals interesting differences between the Swiss cantons. Only 58 percent of Swiss cantonal tax authorities believe that mistakes in reported incomes are, on average, in favor of taxpayers. 31 percent believe that mistakes are neither to the advantage nor to the disadvantage of taxpayers, and 12 percent believe that mis-

takes are to the disadvantage of taxpayers. These answers indicate that distrust towards taxpayers is not universal. If a taxpayer does not report his or her true taxable income, tax authorities contact her in several ways. 54 percent of the cantons phone the person concerned and ask how the mistake(s) occurred in the tax declaration and how it can be explained. All of the cantons send a letter to the taxpayer, half of them with a standard formulation. Nearly 85 percent ask the taxpayer to visit the tax office, but only half of the cantons mention the possibility of punishment. Thus, while one half of the tax authorities rarely adopt the strategy of explicit deterrence, the other rather seeks to gain additional information. 96 percent of the cantonal tax authorities correct reported incomes that are too high, i.e. reduce taxable incomes when taxpayers commit mistakes that are to their disadvantage. 27 percent of the tax authorities correct reported taxable income even if taxpayers fail to profit from legal tax savings.

The impact of the treatment of taxpayers on tax evasion is studied more thoroughly in a regression analysis by Frey and Feld (2002) and Feld and Frey (2002). With a sample of 26 Swiss cantons in the years 1970-1995, they show that the tax authorities in Switzerland do indeed behave *as if* they were aware of the reaction of taxpayers to being treated with respect or not. According to the empirical findings, tax evasion is lower, the more fully the tax office observes formal and informal procedural rules. The observation of procedural rules is indicated by a distinction between friendly treatments, for example a respectful procedure, and unfriendly treatments, like an authoritarian procedure or the tax authorities' direct deterrence to fine. It can be shown that the friendly treatment has a stronger dampening effect on tax evasion particularly in cantons using referendums and initiatives in political decision-making, while the authoritarian procedure, the threat of deterrence, is particularly reducing tax evasion in representative democracies, but counter-productive in direct democracy. Moreover, Swiss citizens are the more respectfully treated by the tax authority the more strongly developed citizens' participation rights (Feld and Frey 2002a). In addition, tax authorities in more direct democratic cantons appear to give taxpayers more frequently the benefit of a doubt. Feld and

Frey (2002a) report evidence that tax authorities in more direct democratic cantons believe to a significantly lesser extent that mistakes in the tax declaration are in favor of taxpayers.

## **5 The Role of Tax Amnesties**

How tax amnesties affect tax compliance is intensively debated in the literature. Two main arguments oppose each other. On the one hand, offering a tax amnesty, taxpayers are given the opportunity to return to normal and honest compliance behavior. This is the well-known bridge to tax honesty often stressed by governments. On the other hand, previously honest taxpayers may be negatively affected by tax amnesties. They could have the impression that it finally pays off to behave dishonestly and get away with only small penalties. Moreover, when they had illusions about the true extent of tax evasion of their fellow taxpayers, they may realize that tax evasion is much more widespread and may fear that they are the last to pay their taxes honestly. This will induce them to comply to a lesser extent with the tax law.

Including tax amnesties in the standard economic theory of tax evasion, the negative effects must be emphasized. Tax amnesties reduce the credibility of governments to commit to a deterrence policy and thus lead to a decline of actual deterrence. The analytics of the psychological tax contract allow for the inclusion of the positive argument for tax amnesties, however. The state is reaching out to renew that contract with taxpayers who became non-compliant in the past being confident that the components of fiscal exchange now fit those taxpayers needs and wishes better than before. When this is done very infrequently, e.g. only every two generations, the negative side effects on honest taxpayers could be kept moderate. From the governments' perspectives, the additional fiscal revenue is often key for tax amnesty proposals. This desire stands in stark contrast to the requirement that tax amnesties should take place infrequently.

In general, tax amnesties do not generate much additional revenue for governments (Alm & Beck 1990, Hasseldine 1998, Feld 2003). Alm, Martinez-Vazquez & Wallace (2001) drawing lessons from Russian tax amnesties support this conclusion. In addition, they find that tax amnesties generate higher revenue when accompanied by bigger changes in the tax system, often reductions of the tax burden, and that taxpayers must perceive a tax amnesty as a one time opportunity. The revenue impact is becoming smaller when tax amnesties occur repeatedly (Luitel & Sobel 2007). Interestingly, the introduction of a tax amnesty in U.S. states depends on political economic factors (Le Borgne 2006). States with high tax levels are more likely to introduce tax amnesties (Dubin, Graetz & Wilde 1992), but also when state indebtedness is growing (Le Borgne 2006). Amnesties are thus perceived by governments as potential revenue raising means. Moreover, governors are half as likely to declare a tax amnesty during an election year, because law-abiding taxpayers consider a tax amnesty as unfair and would electorally punish governors. This evidence supports the argument of negative side-effects of amnesties.

Torgler & Schaltegger (2005) have conducted a tax amnesty experiment in which a referendum on the introduction of a tax amnesty is incorporated. They find that taxpayers usually refuse a tax amnesty. However, tax compliance rises significantly after the vote occurred. In those cases a tax amnesty is accompanied by higher enforcement mechanisms, a higher tax compliance results. It is most interesting to note that the last federal tax amnesty in Switzerland in 1968 became a success because it had to pass a referendum and was accompanied by *less* auditing efforts than a previous proposal (Pommerehne & Zweifel 1991). In this case, the return of taxpayers into honest behavior dominated the crowding-out of honest taxpayers.

## **6 Conclusions**

In this paper, we have argued that tax compliance results from a complicated interaction of deterrence measures and responsive regulation. Citizens and the state develop their fiscal rela-

tionships according to a psychological tax contract that establishes fiscal exchange between taxpayers and tax authorities. It reaches however beyond pure exchanges and involves loyalties and ties between the contract partners. Tax morale is therefore a function of (1) the fiscal exchange where taxpayers get public services for the tax prices they pay, (2) the political procedures that lead to this exchange and (3) the personal relationship between the taxpayers and the tax administrators.

In particular the empirical evidence on Switzerland summarized in this paper underlines these arguments by showing a family of tax jurisdictions where something like a psychological tax contract appears to be in place. There, the tax authorities take into account that the way they treat the taxpayers systematically affects the latter's tax morale, and therefore their willingness to pay taxes, which in turn affects the costs of raising taxes. In addition, tax compliance in Switzerland is shaped by direct democracy establishing a fiscal exchange relationship between taxpayers and the state. This also holds for the last successful tax amnesty in Switzerland although much more complicated issues are at stake when tax amnesties are introduced. Although the empirical evidence provided relates to Switzerland (and the U.S.), we are confident that the issues here considered are valid more generally.

The contractual view adopted in this paper allows for a coherent consideration of the impact of emotions and personal attitudes on tax compliance behavior as it is emphasized in the psychological literature. It also goes beyond the arguments for responsive regulation provided by Ayres & Braithwaite (1992) by suggesting that *genuinely* rewarding taxpayers in an exchange relationship will increase tax compliance. It should thus be considered as the dominant strategy to approach taxpayers in order to enhance their tax compliance, while it is still able to resort to punishment if that strategy fails. The theoretical argument of a psychological tax contract thus has the ability to bridge economics, law and policy.

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