



## Individual, cognitive and cultural differences in tax compliance: UK and Italy compared

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### ABSTRACT

Five hundred and five Italian psychology and economics students took part in a tax compliance study testing the influence of detection rates (within subjects) and the between subjects variables of framing effects, instructions to behave instrumentally or not, degree choice and gender. The sample was an improvement on a previous study conducted in the UK where the effects of gender and degree choice were entangled. The results from the Italian sample showed highly significant effects for detection rates, framing effects, gender and degree choice. Participants declared more as detection rates rose and when tax was framed as a gain. Males and economists declared the least. The instruction to maximise income (instrumentality) encouraged psychologists to declare less, while economists behaved instrumentally whether they were asked to or not. The influence of culture was examined by comparing the two data sets. Although the tax systems of these two countries are very similar, tax evasion is much more common in Italy. As anticipated Italian students declared less than UK students and the results for the Italian sample were more pronounced (e.g. the significant framing effect) but otherwise all are in the same direction. Theoretical and practical implications are discussed as the prospects for future empirical studies.

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## 1. Introduction

In Allingham and Sandmo's (1972) frequently cited article, Rational Economic Man (REM), in the context of tax compliance, will maximize net expected utility. The tendency will be to evade taxes, tempered only by the probability of detection, the level of any subsequent fines and the individuals' degree of risk aversion. While this model is generally accepted within Economics (and there is some empirical support, Cowell, 1985) there are also some well known limitations, three of which are relevant here. First, irrespective of risk aversion, the model can only predict pooled equilibria where all individuals evade or comply, when the evidence is that some evade and some comply. Second, the model under-predicts the extent of tax compliance e.g. there is a high level of voluntary compliance in countries like the USA and the UK where audit rates are relatively low. Third, the model treats tax evasion as the equivalent of a willingness to take part in an illegal gamble, ignoring evidence that individuals do not see evasion this way (Baldry, 1984). These criticisms motivate greater empirical analysis of the

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decision to evade tax. While deductive theory is the 'gold standard' within Economics, in other Social Sciences there is greater reliance on an inductive approach to theorising and it is in this inductive context that the following empirical work is reported. One of the main propositions here is that the impact of culture and individual differences may be as relevant as the parameters of an assumed gamble.

### 1.1. Individual differences and culture

The universality of REM has been called into question both at the level of individuals (Frank, Gilovich, & Regan, 1993) and of culture (Alm & Torgler, 2006). Frank et al. (1993) revealed that people who study Economics are more likely to be self-interested and instrumental and therefore would be expected to be less likely to voluntarily comply with a tax system and more likely to see tax evasion as a gamble. Women tend to be more compliant in tax evasion experiments (Webley, Robben, Elffers, & Hessing, 1991). Cullis, Jones, and Lewis (2006) have also indicated that female students are less likely to evade in a tax evasion experiment although their findings are confounded by the degree studied as fewer women study Economics. At the level of culture Alm and Torgler (2006) convincingly show that different countries have varying degrees of "tax morale" which influence tax compliance. Tax morale is more favourable and tax compliance is highest in the USA; tax morale is low and tax compliance is low in European countries which include Belgium and Portugal. These variations are difficult to explain solely in terms of the financial constraints that people face in these countries. The implication of these studies is that people behave differently in different cultures, but how does this come about? The measure of tax morale may consist of a single question as to the degree to which tax evasion is justified or not, to more complex assessments of the perceived fairness of tax systems and the perceived legitimacy of governments. Whatever measure is used the Social Science analysis suggests that the attitudes and values of citizens influence their fiscal behaviour (Kirchler 2007; Lewis, 1982). How does this relate to the concept of REM narrowly defined? One interpretation is that the tendency to be instrumental (or not) can be determined by attitudes, values and cultural expectations. Another interpretation is that instrumentality itself may be unevenly distributed; it may all depend on how you have been socialized and how you think.

### 1.2. Framing

Since the award of the Nobel Prize in Economics to the cognitive psychologist Daniel Kahneman (along with the experimental economist Vernon Smith) in 2002 behavioural economics (and even more recently behavioural finance) has gained legitimacy even in the rather rarefied world of mainstream economics (Camerer, Lowenstein, & Rabin, 2004; McCaffery & Slemrod, 2006). In this new tradition researchers and policy makers have turned their attention to "framing effects". A robust result is that when people are given a choice framed as a gain, participants are risk averse while at the same time being risk seeking for the same choice framed as a loss (Kahneman & Tversky, 1979; Levin, Gaeth & Schreiber, 2002; Levin, Schneider, & Gaeth, 1998). It could be that whether or not tax evasion is treated as a gamble depends on the context. If a tax system is devised where sufficient tax has yet to be paid, when a payment is due this could be viewed as a loss and Prospect Theory would predict that tax evasion would be more likely. Alternatively a tax system which has already collected too much, resulting in a rebate on completion of a tax return would be perceived as a gain inhibiting risky tax evasion. This interpretation has been supported by Kirchler and Maciejovsky (2001), who found that among their sample of 60 self-employed respondents, an unexpected refund led to high compliance, whereas a surprise demand led to low compliance. Even stronger evidence comes from an analysis of US Internal Revenue Statistics which shows that compliance decreases and tax returns contain more errors after demands for supplementary payments (Cox & Plumley, 1988; Schepanski & Shearer, 1995).

### 1.3. Methodological considerations

Previous inductive empirical work on tax evasion has taken many different forms including the use of questionnaires, interviews, computer simulations and laboratory experiments. In Behavioural and Experimental Economics it has been common practice to pay respondents as well as asking participants to maximise their income in the procedural instructions. In Psychology and other Social Sciences this practice is almost totally absent (Bardsley, Cubitt, Loomes, Moffatt, and Starmer, in preparation). Torgler (2002,2003) has questioned whether instructions to maximise income in behavioural economics experiments is methodologically justified. If REM is to be found everywhere, instructions to maximise income would be redundant as almost everyone would do it naturally. If on the other hand instrumentality does not come naturally the instruction requires people to do what they would not otherwise do. These considerations inform the design of the study reported here<sup>1</sup>.

### 1.4. Rationale and objectives

The current study has four objectives. The first is to test empirically one of the assumptions of the Allingham and Sandmo model, namely that the amount of tax evaded/tax declared is a function of the detection rate. The second is to determine

<sup>1</sup> Half the participants were asked to do what they would do in these situations and half were asked to answer the questions with the objective of maximising income. Strictly speaking this is at odds with the Allingham and Sandmo model which relates to maximisation of expected utility, not expected income, however in a pilot study it became clear that the psychologists, who comprised 50% of the sample, did not understand what expected utility was.

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