



# Compliance costs caused by agency action? Empirical evidence and implications for tax compliance



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## ABSTRACT

Compliance costs of taxpayers should not only be affected by the tax law itself but also by its implementation through the tax authorities. In this paper we analyze the effect of authority behavior on the burden of complying with tax regulations. Using survey data of Belgian businesses, we develop an estimation strategy to overcome simultaneity bias by the construction of proxy variables. According to our estimate, a customer-unfriendly tax administration increases the average compliance burden by about 27%. Our outcome has interesting implications for further research. First of all, authority behavior does not only affect “soft” tax compliance factors like fairness and trust, but also “hard” aspects like costs. Second, the distribution of administrative cost burdens between the taxpayer side and the authorities may be important regarding the cost-efficiency of the tax system as a whole.

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## 1. Introduction

Within the economic literature, there is an extensive and still ongoing debate to which extent tax evasion is affected by “hard facts” like fines, detection probabilities, tax rates and costs and “soft facts” like tax morale, social norms, perceived fairness and trust (Alm, Cherry, Jones, & McKee, 2010; Blumenthal, Christian, & Slemrod, 2001; Cullis & Lewis, 1997; Fellner, Sausgruber, & Traxler, in press; Hasseldine, Hite, James, & Toumi, 2007; Slemrod, Blumenthal, & Christian, 2001; Torgler & Schneider, 2009; van Dijke & Verboon, 2010).

Initially, economic research in the tradition of Allingham and Sandmo (1972) concentrated on the “hard fact” side based on models of rational agents. However, it soon turned out that this approach was not sufficient to explain the relatively high compliance rates compared to the low detection probabilities (for a review see Andreoni, Erard, & Feinstein, 1998; Cullis & Lewis, 1997; Sandmo, 2005). As a result, there was an increasing interest in “soft” aspects that have nowadays found their path into the modelling of economic agents (Hokamp & Pickhardt, 2010; Prinz, 2010).

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An approach to consider both aspects is the “slippery slope” framework (Kirchler, Hoelzl, & Wahl, 2008; Mühlbacher & Kirchler, 2010) accounting for “enforced compliance” and “voluntary compliance”. According to this framework, “enforced compliance” is mainly affected by the power of the authorities and “voluntary compliance” by the trust in authorities. While there is some evidence for these hypotheses (Fischer & Schneider, 2009; Mühlbacher, Kirchler, & Schwarzenberger, 2011; Wahl, Kastlunger, & Kirchler, 2010), it remains still an unsolved question of research, which factors in detail affect both dimensions of tax compliance and what is the relationship among them.

In recent experiments, Alm, Cherry, Jones, and McKee (2010) and McKee, Siladke, and Vossler (2011) find evidence that the provision of taxpayer services has a negative impact on the degree of tax evasion. From the viewpoint of the “slippery slope” framework, this could result from an increased trust in authorities with a positive impact on “voluntary compliance” (Kirchler, Hoelzl, & Wahl, 2008; Wahl, Kastlunger, & Kirchler, 2010; Worsham, 1996).

On the other hand, it may be argued that supporting private taxpayers by taxpayer services reduces their compliance costs resulting from taxation (Alm, Cherry, Jones, & McKee, 2010). While the impact of tax complexity and ambiguity on the compliance level may be either positive or negative (Alm, Jackson, & McKee, 1992; Alm, Cherry, Jones, & McKee, 2010; Krause, 2000; Worsham, 1996), there is some evidence that compliance burdens increase the taxpayer’s willingness to evade (Erard & Ho, 2003). From this perspective, a “customer-oriented” agency could support taxpayers in filing their returns to reduce compliance burdens and to combat tax evasion. Thus, it seems to be an interesting question of research if there is a sufficiently strong impact of tax authority behavior on the compliance costs of private taxpayers.

In spite of a considerable number of studies measuring the burden of tax compliance (for a review see Allers, 1994; Evans, 2003; Vaillancourt & Clemens, 2008), there is still a lack of empirical evidence regarding the impact of authority behavior. Apart from a preliminary analysis of Eichfelder, Kegels, and Schorn (2011) not controlling for potential simultaneity bias, we are not aware of any study in this field. Therefore, it is the purpose of our paper to confirm and to quantify the impact of tax authority behavior.

As data source, we rely on a survey provided by the Federal Planning Bureau in Brussels. The file includes estimates of tax compliance costs on a firm-level basis as well as Likert scale ratings on tax authority behavior. To overcome the simultaneity between both self-reported parameters, we define proxy variables relying on the variation of different rating categories. Thus, our study can also be considered as a methodological contribution to overcome simultaneity bias in survey data.

The paper is organized as follows. Section 2 presents the data. Section 3 documents the estimation strategy and presents and discusses the results. Section 4 concludes the paper. The Appendices A–C contain relevant parts of the survey questionnaire, additional regression results and cross checks.

## 2. Data

Our investigation uses a survey of Belgian businesses that has been carried out by the Federal Planning Bureau in Brussels on behalf of the Belgian government to obtain consistent estimates of the aggregate tax compliance burden. The data contains costs resulting from compliance with Belgian business taxes<sup>1</sup> as well as statements on administrative quality. It consists of four cross sections in 2000, 2002, 2004 and 2006 representing the Belgian population in terms of business size, legal form and industry.

It has to be noted that the data is not a panel, as most of the firms participate in only one year. For each year, there are two sub-samples (incorporated enterprises and independent self-employed taxpayers). An overview of the relevant research questions is presented in Appendix A. The sample sizes and response rates of the aggregate data (including the compliance costs of tax, employee and environmental regulations) and the tax data (including exclusively tax compliance costs) are reported by Table 1 (for further information see De Vil & Kegels, 2002; Janssen, Kegels, & Verschuere, 2006; Joos & Kegels, 2004; Kegels, 2008). Our analysis is based on the tax data with 1,590 usable responses. The response rates of the tax samples are very close to the survey response of the aggregate samples.

We observe lower response rates for the self-employed in all survey years. As survey response of small businesses is typically low (Kayser, Clemens, Wolter, & Schorn, 2004, p. 43; Sandford, 1995), this is not unexpected. A plausible explanation is the limited information capacity and the high workload of self-employed businesses. The relatively low response rates in 2000 should result from problems with the telephone hotline. In addition, there has been only one reminder letter in this survey year (De Vil & Kegels, 2002).

To our knowledge, the data is the best information source concerning the tax compliance costs of Belgian businesses. Nevertheless, some measurement issues should be taken into account. The survey response is lower than in a number of previous studies (for a review see Evans, 2003; Vaillancourt & Clemens, 2008), but not unusual compared to other business surveys (Allers, 1994; OECD, 2001; Slemrod & Venkatesh, 2002). The effect of a possible non-response bias on cost estimates is not obvious, as there are theoretical and empirical arguments for an overestimation as well as an underestimation.<sup>2</sup>

The approach of cost measurement corresponds to previous research (European Communities, 2004; OECD, 2001). Cost estimates are based on personal statements of the requested businesses. The questionnaire considers the time effort

<sup>1</sup> The most important business taxes in our data are the business income tax and the value added tax (VAT). Furthermore, the data includes compliance costs resulting from other business taxes like customs and property taxes. Employment taxes and social insurance contributions are not included. They are part of additional statistical material of the Federal Planning Bureau.

<sup>2</sup> Pressure on political authorities may be an incentive for taxpayers with high compliance costs to participate. Nonetheless, these taxpayers may also be reluctant to take part, because they do not want to waste their time. Empirical evidence is mixed (Allers, 1994; Rametse & Pope, 2002).

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