Reciprocal relationships in tax compliance decisions

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Abstract

Reciprocity considerations are important to the tax compliance problem as they may explain the global dynamics of tax evasion, beyond individual tax evasion decisions, toward a downward or upward spiral. To provide evidence on reciprocity in tax compliance decisions, we have conducted a laboratory experiment in which we introduced two types of inequities. The first type of inequity is called vertical, because it refers to inequities introduced by the government when it sets different fiscal parameters for identical taxpayers, while the second type of inequity is called horizontal because it refers to the fact that taxpayers may differ in tax compliance decisions. In this setting, taxpayers may react to a disadvantageous or advantageous inequity through negative or positive reciprocal behaviors, respectively. Our results support the existence of negative and positive reciprocity in both vertical and horizontal cases. When both inequities come into play and may induce reciprocal behaviors in opposite directions, the horizontal always dominates the vertical.

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1. Introduction

Among the sources of unfairness that affect how individuals report their income to the authorities, one finds differences in tax policy parameters, levels of public goods provided or differentiated opportunities and levels of compliance among taxpayers. More precisely, these factors can be classified in two groups, that correspond to the two relationships that are analyzed in the literature on tax evasion: first, the vertical relationship between the public sector and the taxpayers (Alm, Bahl, & Murray, 1993; Torgler, 2003) and, second, the horizontal relationship between taxpayers themselves. Most of the time, these two relationships are studied as if they were independent from each other with the aim of confirming whether unfairness acts as a potential factor that neutralizes feelings of guilt and pushes taxpayers towards more evasion. One of the rare exceptions – to our knowledge – is Schnellenbach (2010), who provided a theoretical analysis of tax evasion through reciprocal reactions to both types of inequity. He argued that, since there are at least two potential sources of unfairness, two
types of reciprocity are at work in the tax evasion decision. First, taxpayers evade taxes to retaliate against a non-cooperative and unfair government. Second, one individual’s evasion increases if he or she believes that other taxpayers also evade. As a consequence, the dynamics of tax evasion towards an upward spiral of evasion is explained because individuals reciprocate.

In this paper, we adopt the same perspective and, following Schnellenbach (2010), we test the existence, nature and relative weights of vertical and horizontal reciprocal reactions in the reporting decisions made by taxpayers. But, we also depart from his analysis, and this constitutes the originality of our approach, by allowing for disadvantageous and advantageous inequities in both relationships, which respectively worsens or improves a taxpayer’s perceived situation, and potentially induces negative or positive reciprocal behaviors. Indeed, unfairness has a negative and a positive side, since when some individuals suffer from unfairness, others necessarily and unavoidably benefit from it. Therefore, it is not only disadvantageous but also advantageous inequity that affects income reporting decisions. For instance, an advantageous inequity may increase taxpayer’s guilt feelings and as a result increases overall reported income and reduces evasion to the benefit of all. It might then improve the dynamics of tax evasion towards more compliance. We thus claim that a more precise understanding of reporting decisions has to take into account not only disadvantageous but also advantageous inequities in both the vertical and the horizontal relationships that characterize tax decisions. This is what we do in this paper because we consider that the positive side could also add new behavioral phenomenon.

More precisely, we analyze the consequences of perceived unfairness on tax evasion decisions and the overall dynamics of tax evasion by studying both inequities simultaneously. Because vertical and horizontal inequities are likely to occur at the same time, analyzing their interaction effects is relevant since this can be useful for public policy implementation as they may explain the long term dynamics of tax evasion. This is all the more true when vertical and horizontal inequities work in opposite directions since when implementing public policy one needs to have an idea of the effect resulting of such interaction. Their impact is only predictable when the two types of inequities work in the same direction. For instance, in case of disadvantageous inequities, Schnellenbach (2010) showed that horizontal inequity had feedback effects on the vertical one through guilt. Taxpayers may evade because the tax system is unfair and the more they received social information on the extent of tax evasion by others the less they felt guilty to do so and evasion increased. As a consequence, the aim of our paper is to characterize the reactions of taxpayers through reciprocal behaviors in each case. We also attempt to detail the link between vertical and horizontal unfairness, as we agree with Schnellenbach (2010) on: the heterogeneity of taxpayers’ type in the population, the intuitive role of guilt in the tax evasion decision, and the potential rationalization and neutralization of these feelings of guilt when tax evasion is seen as a widespread practice among citizens. However, we also believe that guilt increases, at least for some individuals, when they perceive that very few taxpayers fail to pay their taxes. Individually and socially, tax evasion is then seen as a morally reprehensible practice.2

To reach our objective, we conducted a laboratory experiment to highlight the impact of unfairness on reporting decisions and whether this may induce reciprocal reactions or not. We focused first on vertical inequity by introducing different tax rates among homogeneous individuals. Next we studied the impact of horizontal inequity by providing social information, and finally we analyzed the joint effect of both inequities. We find that introducing a disadvantageous vertical inequity alone decreases the number of evaders while the introduction of an advantageous vertical inequity alone only slightly decreases the level of evasion. We also show that social information affects reporting decision: whether individuals report an income lower or higher than the average of their group they tend to come closer to it. Finally, the main finding of our experiment is that when both inequities co-exist, the impact of social information always dominate any vertical inequity. This result underlines the importance of a joint study of vertical and horizontal inequities to overtake short term considerations and consider the overall dynamics of reporting decisions. Communicating on the fairness of the system may be less efficient compared to a better designed diffusion of social information on tax evasion extent or frequency.

The paper is organized as follows. Section 2 briefly reviews the literature. Section 3 presents the theoretical predictions of taxpayers’ decision. Section 4 exposes the experimental design and procedures. Section 5 presents the results and Section 6 provides our conclusions.

2. Related literature

The tax compliance decision has been under study since the seminal theoretical work of Allingham and Sandmo (1972).3 This work was rapidly followed by several economic and psychological studies that underlined the relevance of fairness considerations, in explaining tax evasion behavior (including Bordignon, 1993; Cowell, 1992; Falkinger, 1995; Kirchler, 2007; Spicer & Becker, 1980; Torgler, 2007). Fairness considerations may refer either to the vertical relationship between the public sector and taxpayers or to the horizontal relationship between taxpayers. Because our study attempts to deal with both inequities, our work is related to these two areas of research that have been analyzed separately until now.

A first wave of the literature has focused on the unfairness of the tax system itself, which alters taxpayers’ behavior (Cowell, 1992; Falkinger, 1995). This is in line with Frey (1997) and Feld and Frey (2010) works on the crowding out of tax compliance as a civic virtue when government policies are perceived as unfair. In this case, initially honest taxpayers may start...
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