



Tax evasion and the psychology of the social contract

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Abstract

In a common assumption of the economics of tax evasion, extending beyond the basic Allingham–Sandmo model, the choice of a taxpayer to evade taxes depends upon the perceived fairness of the tax system. The purpose of the paper is to provide a psychological foundation for this assumption by drawing on Hayek's theory of human behavior as a process of rule following. According to the main hypothesis, taxpayers are more compliant with tax laws to which they can in principle give their full consent. People tend to keep to a conceptual social contract at least in some degree like to contracts of a more ordinary kind because of limitations on their information and cognition, generalized conditioning and feelings of self-determination.

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1. Introduction

Two major issues, the economic analysis of tax evasion deals with, are the extent to which taxpayers choose to comply with tax laws and the means to enhance such compliance. The social desirability of the choices of taxpayers to evade taxes and the efforts of the government to prevent cheating depends on the acceptability of the tax laws themselves. For example, if the government is in the possession of a despotic autocrat who squanders most of the tax

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revenue on his private trifles, tax evasion may be a symptom of a legitimate discontent of the people and an effective means to restore a government under the law.

A variety of criteria are used in economics to evaluate tax laws, like laws in general, from a social point of view. The approach of this paper is contractarian and, accordingly, we judge a tax to be “good” in a moral sense insofar as all the members of a community would give their consent to the tax voluntarily if they had to choose without knowing any particulars of their circumstances. An evasion of a tax by parties to such a social contract is unacceptable because, like all other breaches of contract in the community, it constitutes a violation of the contract rights of the other parties.

In their seminal paper, [Allingham and Sandmo \(1972\)](#) explain tax evasion by assuming that the taxpayer maximizes his or her net income through rational balancing of the probability of being caught for evasion, the expected penalty, and the degree of risk aversion. The students of tax evasion have later extended this rudimentary model in a number of different ways. Tax compliance is assumed to increase, for example, when taxpayers feel guilt or shame for breaking the tax code ([Erard and Feinstein, 1994](#)), when they observe other taxpayers comply ([Myles and Naylor, 1996](#)), or when they regard the fiscal system as basically fair ([Cowell, 1992](#)). The extensions are typically based on mere assumptions of human behavior, without any rigorous effort to explain *why* in fact taxpayers behave as presumed. The purpose of this paper is to apply an analysis of human psychology, rather than to use *ad hoc* assumptions, to give reasons for the conceived fairness of taxation to have an effect on compliance. One of the advantages of the psychological analysis is that it may help tax policy makers by providing tools that go beyond simply treating the symptoms of tax evasion ([Lewis, 1982](#), p. 127).

The main conclusion of the paper is that the very contractarian approach we adopt to evaluate the social desirability of taxation is also of use in explaining the decisions of taxpayers to comply with the taxation. In order to reach the conclusion, we start in [Section 2](#) by arguing that taxpayers, like human decision-makers in general, tend to follow rules they know or trust to have produced good results in the past. Honesty can be a highly useful rule in many situations, and taxpayers may follow it, due to effective conditioning or failures of discrimination, even when dishonesty would better advance their private interests. We argue in [Section 4](#) that “honesty mode” tends to be activated when taxpayers can agree on the tax laws and, before this in [Section 3](#), that such unanimous consent of taxpayers is in principle attainable under certain conditions. Combining the findings, [Section 5](#) gives practical suggestions that authorities might use to discourage tax evasion.

The analysis throughout the paper is confined to personal income tax. While the government can obviously lose revenues from income tax as a result of cheating on the part of individual taxpayers as well as firms enjoined to do the withholding, attention here is paid solely to the evasive motives of taxpayers.

The inspiration for most of the subsequent analysis goes back to the inquiries into social reality by scholars in the Austrian school of economics. The notion of decision-making as a process of rule following is based on the psychological theory Hayek advances in *The Sensory Order* (1952). The view of a social contract, approved by all members of a society, as the foundation of welfare economics is based on the contractarian theory of [Buchanan \(1959\)](#), whose emphasis on subjectivism shares many elements cherished by the Austrians.

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