CHAPTER 15

TAX EVASION

VALERIE BRAITHWAITE

Tax evasion is a crime that adversely affects a nation’s economy and the tax morale of citizens by reducing the nation’s capacity to provide government services or manage its debt and by placing a disproportionate burden on those who pay their share (Burman 2003; Bajada and Schneider 2005, pp. 3–5; Kirchler 2007, p. 24). Tax evasion has political as well as economic significance (Internal Revenue Service 2005b). Institutions of taxation are part of how nations define themselves (Schmölders 1970; Stiglitz 2002, p. 177), and taxes regulate activity (J. P. Smith 1993; Mumford 2002, pp. 6–7; Moran 2003). For instance, taxes on tobacco increase price disincentives for dangerous consumption (Geis, Cartwright, and Houston 2003). Taxation also makes a statement about how a society practices social justice, expressing a nation’s values regarding resource redistribution from the rich to the poor (progressive taxation) or from the poor to the rich (regressive taxation; Stiglitz 2002, p. 177). Taxes can deepen the oppression of taxpaying communities, at times with catastrophic consequences (for example, wars of independence in the United States and India or revolution in France).

In stable democracies with well-established taxation institutions, state-citizen reciprocity underlies most people’s understanding of taxpaying (Scholz and Lubell, 1998a, 1998b; Frey and Feld 2001; Rawlings, 2003; Feld and Frey, 2007). In some circumstances, however, paying tax may be regarded as little more than legally ordained extortion. Presumably for this reason, Moran (2003, p. 378) offers the following definition: “A tax occurs when a government requires contributions for its operations from individuals, firms, or groups within its jurisdiction without returning a clear quid pro quo.” Feeling reciprocity is a subjective social phenomenon, and as Moran implicitly recognizes, cannot be imposed on an individual who pays tax.

Nevertheless, reciprocity and obligation occur in taxpaying insofar as a “psychological contract” is made between the taxpayer and the state (Frey and Feld...
2001; Feld and Frey 2007). This extra layer to Moran’s (2003) definition means that citizens and taxpayers generally buy into taxpaying as an obligation. In return, governments provide the community with infrastructure and services. When government fails to deliver expected and promised benefits to the satisfaction of taxpayers, discontent is expressed as a breach of trust (Scholz and Lubell 1998a, 1998b; Feld and Frey 2002; Rawlings 2003).

At sufficiently high levels tax evasion signals a threat to a society’s economic security, political stability, and social capital. It is no surprise, then, that the regulation of taxpaying is well institutionalized in mature democracies. The institution depends on social mores and elaborate systems of tax law and procedure. In many democratic societies the law is complex, the administration cumbersome and bureaucratic. The remarkable feature of these tax systems is that they work as well as they do (Alm, McClelland, and Schulze 1992), but there is widespread belief that they are in trouble, with a growing gap between expected and collected taxes (Hasseldine and Li 1999; Avi-Jonah 2000; Tanzi 2000; Rossotti 2002; Burman 2003). In a globalized world where wealth is mobile and sovereign states are unable to successfully identify and isolate the wealth that is “theirs” to tax, tax evasion is not easy to track down (Tanzi 1996). Pinpointing evasion is made difficult by different tax laws in different countries (Moran 2003), complexities in tax law that generate uncertainty (Picciotto 2007), and an attitude to the law that makes it fair game for exploitation by those who abide by black letter interpretation while dismissing the spirit that the law embodies (McBarnet 1992).

In this chapter I briefly map the domain of tax evasion, draw on the best data available from the United States to illustrate the magnitude of the problem, review the scientific literature on the primary drivers of tax evasion, and consider some of the strategies that governments are using to try to rebuild the effectiveness and integrity of their tax systems to ensure future sustainability. The main conclusions are the following:

- Tax evasion needs to be understood holistically: perceptually, people are capable of linking different forms of taxation to each other and to the quality of governance.
- The nature and extent of tax evasion vary across contexts and time depending on opportunity to evade tax and the enforcement processes in place.
- Efficiency considerations in tax collection influence which groups will be taxed and the success of evasion strategies. The result is that when methods of taxation change the message of moral obligation needs to be renegotiated with the public, particularly in circumstances where commitment to overarching law-abidingness is absent.
- In the United States underreporting of taxable income explains a large part of tax evasion, but tax avoidance through deposits in offshore financial centers lies outside these estimates. Worldwide these deposits are thought to be in excess of $5 trillion.
The wheel of social alignments is proposed as a way of integrating three spheres of tax research: the optimal design of the tax system, the deliberations that enable individuals to voluntarily accept taxpaying (benefits, moral obligation, and justice), and the role played by others beyond the tax authority and the taxpayer (accountants, tax advisors, financial planners, work colleagues, and family). Sometimes these influences are sympathetic to the tax system, other times not.

Interlocking the three spheres of design, taxpayer perceptions, and influential networks to build a cooperative taxpaying culture requires increased engagement of tax authorities with the taxpaying public through high standards of procedural justice, meaningful dialogue, and responsiveness.

I. Domain

Taxes take different forms “depending on each nation’s history, administrative capacity, and culture” (Moran 2003, p. 378). For example, income tax, corporate tax, land tax, capital gains tax, death tax, inheritance tax, sales tax, customs and excise tax, and value-added tax are all available to governments and generally are used in combination, albeit to different degrees in different places. Moran regards levels of economic development as critical to differentiating the tax mix of former British colonies: “Australia, Canada, the United Kingdom, and the United States raise most of their revenues from income, wage, and corporate taxes while the Anglophone African nations and India raise more of their tax revenues from customs duties” (Moran 2003, p. 381). Indeed, the United States, Canada, and Australia raise half of their tax revenue from income tax, while Britain raises a third in this way (Moran 2003).

This is undoubtedly the reason so much of the literature on tax evasion has focused on income tax (an exception is Slemrod 1999). The tax mix, however, matters. Understanding interdependencies and how people see the relative merits of different forms of taxpaying is at the heart of understanding tax evasion. Two examples illustrate, one in the area of development, the other in the area of corporate taxation.

Global pressures on developing countries to lower trade barriers is particularly detrimental to poorer nations that have a tax mix that is heavily weighted toward customs and excise duties (Moran 2003). As underresourced and inexperienced tax administrators are trying to collect customs and excise tax from global business enterprises, they are no doubt grappling with a mixed message about how worthwhile their activities are. It is of little wonder that such tax authorities struggle to establish effective tax systems that will withstand problems of corruption. The degree to which a society can harness a moral imperative to pay tax within its population is an important predictor of levels of tax evasion (Torgler 2003).
The role of the global economy in legitimizing particular forms of tax evasion and undermining efforts to communicate a moral imperative to pay tax calls for further study.

The question of corporate tax contributions is ideologically fraught, with some scholars arguing that entities should not be taxed on their profits if their shareholders and owners are paying personal income tax (Sørensen 1999; Moran 2003). Such a view, however, does not have the support of the general public (Steinmo 1993, p. 158; V. Braithwaite 2003; V. Braithwaite and J. Braithwaite 2006). The economic and social harms caused by the collapse of a corporation such as Enron, which paid no taxes for four of its last five years (J. Braithwaite 2005), have sharpened concerns about corporate social responsibility, including taxpaying (V. Braithwaite et al. 2001; Happé 2007).

Although corporations and the public may be at odds about their “rightful” contributions to the tax system, the reality is that many companies pay no tax at all (J. Braithwaite 2005, p. 20), and most member nations of the Organisation for Economic Co-operation and Development have seen a drop in the proportion of revenue they collect through company tax due to global tax planning by large corporations (Steinmo 1993, p. 20). Profits are moved from countries with high tax rates to those offering more favorable tax conditions, in particular, tax havens. The result has been a race to the bottom as far as corporate and individual income tax rates are concerned (Avi-Jonah 2000; Genser 2001; Maranville 2004).

A policy imperative for governments is to guard against public perceptions of corporate free riding. Such perceptions cast doubt over a government’s capacity to enforce the law and create justification for widespread community defiance (Mason and Calvin 1984; Rossotti 2002; V. Braithwaite et al. 2003). From a policy perspective, evasion in relation to corporate income tax is not disconnected from other types of tax evasion (Schneider and Enste 2002).

II. Magnitude

Estimating tax evasion and avoidance is difficult. Part of the problem is definitional, part is the reliability of data on the magnitude of the problem. Tax evasion can be defined as an illegal act of commission or omission that reduces or prevents tax liability that would otherwise be incurred (Webley et al. 1991, p. 2). Specifying what these acts are is impossible. As Tanzi and Shome (1994, p. 328) explain, tax evasion covers a “truly remarkable” array of activities, continually being invented by those looking for ways of not paying tax.

When attention turns from evasion to avoidance, problems of specification deepen. The distinction between avoidance and evasion has been expressed simply: “It is the difference between working within the law (though against its spirit)
tax law is as complex as it is, opportunities arise for finding loopholes and ambi-
guities, so that “the arrangement of one’s affairs, within the law, to reduce one’s tax
liability” becomes possible (James and Nobes 2000, p. 300) in circumstances where
these actions are “contrary to the spirit of law” (p. 100). Recent legislative changes
in some countries that have introduced general anti-avoidance rules (principles)
have sought to bring avoidance under the control of the legal system (see Jones
1996; Freedman 2004; J. Braithwaite 2005). These general tax principles make it
illegal to act in ways that are counter to the spirit of the law for no other purpose
than to minimize tax (or when the dominant purpose is avoidance).

The Internal Revenue Service (IRS; 2005a, 2005b) has invested heavily in mea-
suring the “tax gap” to provide an estimate of U.S. taxpayers’ compliance with
their federal tax obligations. The tax gap refers to the difference between the tax
that taxpayers should pay and what they actually pay on a timely basis. The data
for 2001 was collected from audits of 46,000 tax returns of individuals. Data for the
corporate contribution to the tax gap was not updated from 1988.

Individual income tax constitutes about half of the tax gap (IRS 2005b). Other
taxes that are included in the tax gap estimate are corporation tax, employment
tax, and estate and excise tax. The IRS has broken down the tax gap into three
forms of evasion: underreporting income, nonfiling of tax returns, and nonpay-
ment of a tax debt. The largest component (80 percent) involves the underreporting
of income (IRS 2005a). IRS (2005a) audits have shown that the majority of individ-
uals underreporting were understating income, mainly from business activities,
rather than overclaiming deductions to reduce their taxable income. The remain-
ing forms of evasion each account for about 10 percent of the tax gap: failure to pay
the reported taxes owed and failure to file a tax return (IRS 2005a).

Of note is what the tax gap does not cover. It does not include taxes from the
illegal sector of the economy (IRS 2005b), which includes crimes of drug traffic-
ing and smuggling of various kinds. Also excluded from the tax gap, because of
its invisibility in many cases, is the “legitimate” work performed by illegal immi-
grants and those who are paid in cash outside the official economy.1 The tax gap
also does not include revenue lost through avoidance measures that the IRS feels
ill-equipped to challenge or that are beyond reach; as an example, Tanzi (2000)
cites the impenetrable veil around transactions in offshore financial centers, citing
a 1998 UN report that estimates that deposits in these centers exceed $5 trillion.

The tax gap for the tax year 2001 in the United States is estimated as falling in
the range of $312 billion to $353 billion (IRS 2005a, 2005b). IRS enforcement activity
and late payments have reduced this gap by $55 billion, that is, by 16 to 18 percent.
Obviously, figures on U.S. tax evasion cannot be generalized to other parts of the
world, nor should it be assumed that the United States is leading the way in tackling
tax evasion. The United States is unusual, however, in the rigorous and systematic way
it has gone about collecting data. Therefore, the U.S. tax gap data are a useful bench-
mark for gauging the seriousness of tax evasion for countries around the world.
Although the dollar value of tax evasion is substantial, most studies confirm that the majority of people pay their tax. Hasseldine and Li (1999) summarize international survey work reporting that about a quarter of people who file a tax return will admit to deliberately underreporting income. Using data from the IRS Taxpayer Compliance Measurement Program audits, Andreoni, Erard, and Feinstein (1998) reported that 25 percent of all taxpayers underpaid their taxes by $1,500 or more. Tax evasion appears to be a relatively common crime, perhaps even the most common. Even so, a very sizable proportion obey the law without the need for intervention (IRS 2005b). Given the low risks of detection and punishment (Rossotti 2002), most people comply with tax law in an economically irrational way most of the time (Alm, McClelland, and Schulze 1992; Andreoni, Erard, and Feinstein 1998).

III. Changes in Tax Evasion

The 2001 analysis of the tax gap led the Internal Revenue Service (2005a) to conclude that there had been “modest deterioration in tax compliance among individual taxpayers since the last study was conducted in 1988.” In 2002 Charles Rossotti, then commissioner of the Internal Revenue Service, reported to the IRS Oversight Board, “We are winning the battle, but losing the war. Over the last ten years, the size and complexity of the tax system increased enormously. Beyond the simple increase in number of taxpayers and revenue dollars, the majority of tax revenues now come from sources that are more subject to manipulation by those who wish to pay less than the law requires and much more difficult and time consuming for our agents to uncover” (pp. 1–2). Rossotti continued with an admission that the IRS had no overall strategy for dealing with corporate tax shelters, had not concentrated efforts on high-income individuals, and had not revised their auditing priorities to focus attention on offshore accounts, partnerships, and trusts through which vast sums of income flowed, resulting in a burgeoning market in “tax schemes and devices designed to improperly reduce taxes to taxpayers based on the simple premise they can get away with it” (p. 2).

IV. What Change Means in the Tax Context

The literature supports Rossotti’s (2002) analysis that swings in levels of evasion at the national level reflect opportunity to evade, created by change in enforcement
activity and by change in socioeconomic conditions that alter ease of collection. Aggressive tax planning, for instance, appears to be responsive to enforcement activity. John Braithwaite (2005) has proposed a cyclical theory of aggressive tax planning that recognizes the role that tax authorities play in signaling what is not acceptable. Braithwaite tracks the way the wealthy engage in tax planning with innovative game plans that are ahead of what tax authorities are looking for in their auditing activities. Schemes that have met with some success at elite levels are then repackaged for marketing to an unsuspecting public eager to jump on the next financial planning bandwagon and save tax. In the repackaging process, many of the niceties that protect against challenges from tax authorities are lost. It is therefore at the mass-marketing stage that tax authorities feel confident that they have the ammunition to challenge the schemes and close them down. By this time promoters have made their financial killing, and small investors are left to their own devices to fight their case against the tax authority. This sequence of elite marketing, mass marketing, and tax authority challenge means that aggressive tax planning occurs in cycles, with the greatest risk occurring at the end of the cycle, when smaller players regard such schemes as safe, smart investments and join the stampede. Until tax authorities become more adept at intervening in a timely fashion tax avoidance activities will fluctuate substantially across time.

Enforcement intervention is not the only factor shaping what the figures tell us about tax evasion over time. As economic conditions change, the costs of collecting a particular form of tax may exceed the revenue collected from that tax. To preserve the tax base without additional collection expense, governments change the tax mix. As the tax mix changes, opportunities for tax evasion will also change.

By tracking Australia’s transition during the twentieth century from having a predominantly customs, excise, and land tax base to an income tax base that relies heavily on wage and salary earners, J. P. Smith (1993) has shown how adaptive tax systems are to changing economic and social conditions. These changes have been used by John Braithwaite (2005) to explain why Australia’s progressive tax regime (like the regime in the United States) has become more regressive in the course of the century. At the turn of the twentieth century, the working classes were poorly paid, itinerant, often working in rural Australia. Collecting tax from such a group was far less cost effective than collecting tax from those with money, land, and inheritance or from highly paid workers in urban areas. As smaller family businesses corporatized and became part of larger companies and as workers found steady jobs with better salaries in urban areas, the opportunity to tax the working classes in a new and highly cost-effective way emerged. Increasing wages gradually drew workers into the income tax net originally designed for the rich, and tax was extracted by employers on behalf of the government at source through a withholding system.

Thus by the end of the twentieth century the tables had turned, not only in Australia, but also in the United States (see Browlee 2000 for the U.S. history). Wage and salary earners were a “captured” population: their income could be
easily tracked through third parties (employers and financial institutions), and tax could be withheld by government. Those with wealth, on the other hand, were able to move their money to places where third-party reporting and withholding tax could be avoided. This is not to suggest that there are no options for the working class to avoid tax. Shadow economy activity leaves no audit trail and occurs commonly when goods and services can be sold or traded completely outside the official economy (Schneider and Enste 2002).

V. SPECIAL FEATURES

The above analysis illustrates tax evasion as a white-collar crime, the substance of which is sometimes poorly specified and changes with economic and social conditions. One might be forgiven for thinking of tax evasion as a failure to comply with “arbitrary” legal rulings (Schmölders 1970). If there is a moral underpinning to tax evasion, it is not transparent in the specific rules (Picciotto 2007). The moral underpinning is more abstract; it is a belief in the rule of law and accepting responsibility for being a law-abiding citizen, or a commitment to the psychological contract between the taxpayer and the state (Frey and Feld 2001; Orviska and Hudson 2002). The relatively abstract nature of the moral underpinnings to taxation probably explains why tax authorities and tax systems so readily look to coercion as their ultimate enforcement weapon, not necessarily through punishment but through a tax design that gives the taxpayer little choice.

VI. THE WHEEL OF SOCIAL ALIGNMENTS

The dominant theoretical lens for understanding tax evasion has grown out of deterrence theory (Allingham and Sandmo 1972), with its presumption that people will evade tax when the benefits of evasion outweigh the costs. However, research findings have led to modification of this basic theoretical model. The odds of detection and penalties are so low that it is mostly rational to cheat, yet people tend to do the right thing and pay their taxes (Alm, McClelland, and Schulze 1992; Slemrod 1992; Alm, Sanchez, and de Juan 1995). Personal interpretations of risk and gain, knowledge of taxation, cognitive heuristics, social norms, shame, guilt, and identity are among the factors that have been shown to influence an individual’s propensity to evade tax (see Webley et al. 1991; Kirchler 2007). Moreover, the process through which these influences operate can involve the individual in a conscious, deliberative assessment of gain and loss, or very little deliberation (V. Braithwaite
Tax evasion can occur through modeling the behavior of significant others (V. Braithwaite and J. Braithwaite 2006) or through the use of general heuristics (Scholz and Pinney 1995; Scholz and Lubell 1998a, 1998b).

The varied and multiple pressures that increase or decrease tax evasion can be integrated for the purposes of policy analysis through the wheel of social alignments depicted in figure 15.1 (V. Braithwaite and Wenzel 2008). The wheel of social alignments displays the segments that tax authorities need to be constantly monitoring and improving in order to collect tax efficiently in keeping with the democratic will. The outer band of the wheel represents the tax system, its laws, codes, and administration. This is the institution of taxation that commonly constrains individuals, makes demands, and ensures that demands are met. Ideally it is also where lie responsiveness to taxpayers (K. W. Smith 1992; V. Braithwaite 2003a), respect for taxpayer rights (Bentley 2007), and tax system integrity (V. Braithwaite 2003d).

The middle band represents how individuals deliberate and make choices about taxation. Opportunities for conflict with the tax authority arise around benefits accrued from contributions, obligation or coercion to make contributions, and justice in collecting contributions. If a tax system is to be sustainable and honor democratic principles, these conflicts must be resolved by most people most of the time in ways that are sympathetic rather than antagonistic to taxpaying.

The inner core of the wheel in figure 15.1 represents “the other” who is sought out by the taxpayer as a role model who affirms the taxpayer’s identity, particularly ethical identity (Harris 2007). The other may be a friend of the tax system or an enemy, or an alternative authority (for example, the financial planning industry).
The other provides taxpayers with direction when personal deliberation leaves them unsure and confused about the demands of the system (the outer band).

The width of the three bands in figure 15.1 varies with culture and context. When tax authorities wish to impose a system without scope for noncompliance (for example, a simple withholding system), the outer band will be wide, leaving the middle band of dialogue with little practical utility and rendering the inner core irrelevant. The situation may change, however, if the tax is unduly oppressive and comes to the attention of the population as harmful or unfair. The middle band and the inner core may then combine forces to weaken the outer rim of institutional constraint. The inner core and middle band are also likely to be wide, comparatively speaking, in a self-assessment system where individuals are required to make an investment in thinking about the tax they are paying.

When taxation is a subject that is deliberated and the state seeks to bring the tax system into line with the democratic will, the outer band, the middle band, and the inner core should all have a noticeable presence. Through dialogue, the bands have opportunity to interlock to form a unified whole that can move forward. The forward movement is propelled by the deliberation that takes place within the community about the tax system: Will it bring benefits now or in the future? Does it elicit a feeling of obligation? Does it resonate with a sense of social justice? If these questions are answered in the affirmative, the wheel moves forward and accumulates the momentum that sets up mutual trust and cooperation between taxpayers and their tax authority. If they are not answered in the affirmative, the wheel may roll backward and disintegrate, or it may oscillate in confusion from feelings of discontent while holding on to some faith in the system. If discontent is squashed and deliberation outlawed, the outer rim operates as a clamp, holding things in place, allowing no scope for movement or development. When processes are in place to respond to concerns and gain forward momentum, the tax regime is optimally effective, operating largely on cooperation and earning such cooperation by acting with integrity.

**VII. Primary Drivers**

In this section I briefly review the literature on why individuals evade tax and discuss all five segments and bands in figure 15.1. Benefits, coercion, obligation, and justice have been identified in the literature as components in the story of why people evade tax (Cullis and Lewis 1997; Tanzi 2001; also see more general reviews by K. W. Smith and Kinsey 1987; Slemrod 1992; Alm, Sanchez, and de Juan 1995; Andreoni, Erard, and Feinstein 1998; Hasseldine and Li 1999). Tax system design also has been linked with evasion, although in the tax design literature the emphasis has been on raising revenue in accord with normatively desirable principles.
(Tanzi and Shome 1994; Brand 1996; Tanzi 2000, 2001). The role of the other in tax evasion has assumed greater importance more recently, adding a dynamic element to how communities come to defy the structural design of the system (Organisation for Economic Co-operation and Development 2001a).

A. Tax System Design and Administration

Drawing on Adam Smith’s four canons of taxation—equity, certainty, convenience, and economy—tax experts such as Tanzi (2000, 2001), Tanzi and Shome (1994), and Brand (1996) converge in their views on what the gold standards of tax design are, and maintain that evasion and avoidance will be lower when good design principles are followed. Of widespread concern is complexity, the central argument being that unintentional evasion increases when there is confusion about what is required (Long and Swingen 1988; Tanzi and Shome 1994; Brand 1996). As well as being simple, tax systems should be cost-effective. Where taxpayer compliance costs are high, compliance is less rational or even impossible (Sandford 1995). K. W. Smith and Stalans (1991) have brought together complexity and psychological compliance costs, suggesting that a simplified tax system would create more comfort for taxpayers (that is, reduce emotional costs), and in this way serve as a positive incentive for compliance. The principles of efficiency and equity involve keeping taxes as low as possible and spreading the burden as widely as possible. In line with these standards is the previously observed need to be sensitive to the different tax mixes of different countries and to curb tax avoidance. Finally, the revenue agency must be designed in such a way that it can prove itself a credible enforcer. Brand (1996, p. 14) expresses this design principle as having “a presence across the spectrum,” being everywhere in the public eye, educating, persuading, and sanctioning.

The above are normative principles of tax design that may serve a broader governance agenda, not simply an agenda of reducing tax evasion. In terms of keeping evasion in check, strong empirical support can be found for some design features, most consistently in limiting the opportunity that would-be tax evaders have for avoiding detection (Wärneryd and Walerud 1982; Witte and Woodbury 1985; Long and Swingen 1988; K. W. Smith 1992; Andreoni, Erard, and Feinstein 1998; Richardson and Sawyer 2001; Taylor and Wenzel 2001). For example, tax withholding systems clearly have worked (White, Harrison, and Harrell 1993; Hasseldine 1998; IRS 2005a, 2005b), not only reducing opportunity for evasion, but also saving on compliance costs, at least for taxpayers and tax authorities. Third-party reporting has also been shown to improve compliance, lending credibility to enforcement capacity in the process (IRS 2005a, 2005b). In the experimental tax literature the probability of audit and of penalties has been associated with less tax evasion (Andreoni, Erard, and Feinstein 1998; Slemrod and Yitzhaki 2002). The evidence for other principles as a means for reducing evasion is more ambiguous. Research on the empirical relationship between tax rates and compliance has
produced mixed results (Andreoni, Erard, and Feinstein 1998; compare Clotfelter 1983 and Feinstein 1991), as has the research on complexity and compliance costs and evasion (Carroll 1992; Richardson and Sawyer 2001).

In all these areas the caveat is how fair and reasonable people regard the actions of tax authorities operating under these principles. Trading complexity for simplicity needs to be balanced against an understanding that complexity is often the cost of governments pleasing their constituents or being fair (Carroll 1992; Warskett, Winer, and Hettich 1998; Slemrod and Yitzhaki 2002). Forest and Sheffrin (2002) demonstrate empirically that unfairness overshadows complexity in the prediction of evasion.

Likewise, the effects of audits and penalties are complex. From the authority’s perspective, these effects need to be sufficiently negative to signal that noncompliance is unacceptable, though not so negative as to undermine enforcement capability. If too heavy, penalties may be applied sparingly by authority, and when applied may lead to lengthy appeals that undercut the credibility of the revenue agency as an enforcer (Tanzi and Shome 1994). Instead of deterring, taxpayers can learn through the process of ineffective audit and successful challenge how to get away with evasion. Even withholding systems can bring risks. There is some evidence that when constraints are tightened in one area of taxation, defiance moves to another area where noncompliance is less easily detected (Yaniv 1992; Ahmed and V. Braithwaite 2005). Tax evasion is like a squishy ball: pressuring one part results in an extrusion elsewhere.

B. Benefits

Empirical evidence for whether perception of benefits from taxation protect against evasion and avoidance is at best partial and indirect, although theoretical work has led to an expectation that such a relationship should exist in the real world (Falkinger 1988). Andreoni, Erard, and Feinstein (1998) reviewed the research on satisfaction with government and concluded that taxpayers who felt that their tax dollars were not well spent may refuse to pay their full tax liability. Richardson and Sawyer (2001) were more circumspect, warning against generalizations because of variations in what is meant and measured when considering satisfaction with government, for example, whether the reference point is satisfaction with government expenditure for the common good or satisfaction with government spending for oneself.

Western democracies are experiencing high levels of disillusionment with government (Dean, Keenan, and Kenney 1980; La Free 1998; V. Braithwaite et al. 2001), and some studies have linked this general form of alienation with tax evasion (Webley et al. 1991; V. Braithwaite et al. 2003). Mason and Calvin (1984) have disputed the claim that individuals who are dissatisfied with government will engage in tax evasion, but they suggest that indirect effects may occur, involving a watering down of the legitimacy of government authority.
Ahmed and V. Braithwaite (2005) found that dissatisfaction with government on tertiary education loans generated dismissiveness of government authority, in turn predicting defiance.

C. From Coercion to Moral Obligation

Each individual is expected to accept his or her legal obligation to comply with the tax laws. If a cooperative response is not forthcoming, coercion makes its presence felt through the revenue authority’s enforcement powers: legal sanctions, social stigma, and appeals to an individual’s conscience (Grasmick and Bursik 1990).

Fear of sanctioning (particularly being caught) has emerged as a significant predictor of tax compliance in some studies (Mason and Calvin 1978; Grasmick and Bursik 1990; K. W. Smith 1992; V. Braithwaite et al. 2003), but not others (Hessing et al. 1992). Effectiveness of deterrence at the level of individuals varies depending on how those individuals engage with the tax system (Hessing et al. 1992; Scholz and Pinney 1995; Wenzel 2004b).

Of particular policy significance is the finding that personal ethical norms can drive tax compliance, with deterrence playing a role when obligation and social pressure fail (Wenzel 2004b). Adherence to personal ethical norms has been investigated in many guises in the tax literature. Moral obligation, ethical responsibility, and anticipated feelings of shame and guilt have emerged as significant factors in containing evasion (Schwartz and Orleans 1967; Grasmick and Scott 1982; Grasmick and Bursik 1990; Porcano and Price 1993) and are regarded as among the most consistent predictors in the literature (for reviews, see Andreoni, Erard, and Feinstein 1998; Richardson and Sawyer 2001).

Mason and Calvin (1984) have pointed out the interdependencies among obligations, sanctions, and legitimate and credible law. They have argued that when compliance norms are allowed to weaken in a society, particularly as a result of perceptions of unfairness, the shared sense of moral obligation and the accompanying guilt feelings also weaken. Coercive efforts to reverse this downward compliance spiral will not necessarily lift moral obligation. They may increase perceptions of unfairness and crowd out a moral commitment to pay tax (Frey 1997).

D. Justice

Although there is evidence that injustice is an important correlate of tax evasion at a general level (Spicer and Becker 1980; K. W. Smith 1992), there is little consistency in the literature on which aspects of injustice precipitate evasion in contemporary Western democracies (Andreoni, Erard, and Feinstein 1998; Richardson and Sawyer 2001; Wenzel 2003). Contextual variation and whether or not justice is salient in the minds of taxpayers have been proposed as likely explanations for this inconsistency of findings (Hite 1997; Scholz and Lubell 1998b).
Both vertical and horizontal equity have received attention in the tax literature because of their normative importance, if not their explanatory significance, in relation to evasion. Horizontal equity is a central tenet for the design of tax systems, ensuring that the same tax is paid by members of groups of comparable taxpaying capacity, both in terms of what is expected and what is actually collected (Dean, Keenan, and Kenney 1980). Vertical equity attracts attention because of its political dimension. In many Western countries, progressivity is widely endorsed as politically desirable. In principle, each should pay according to capacity; in practice, the rich pay more (Slemrod 2000; V. Braithwaite et al. 2001; Edlund 2003). In Australia, as elsewhere (for the United States, see Slemrod 2000; for the United Kingdom, see Commission on Taxation and Citizenship 2000), perceptions of low vertical equity in the tax system invite a great deal of criticism (V. Braithwaite 2003; Rawlings 2003).

Interestingly, experimental interventions have supported the importance of justice. In the United States Hite (1997) was successful in demonstrating improved compliance when a vertical equity message was given for the amount of tax the wealthy pay. Wenzel (2005) had similar success in Australia with a message that others were paying their fair share of tax.

E. “The Other”

“The other” in figure 15.1 comprises tax advisors, friends, family, work colleagues, celebrities, and newspaper columnists—in other words, those with whom we may identify (Sigala, Burgoyne, and Webley 1999; Wenzel 2002, 2004a, 2007). The influence of the other may be pro-tax or antitax. Most of us most of the time take our cue as to what we should do by watching how others observe rules, a form of behavioral modeling that McAdam and Nadler (2005) refer to as the coordinating function of law. For this reason, whenever people pay taxes the predominant role of the other is assumed to be positive. The negative role is nevertheless present as well, most notably when people believe others are free riding the system (Wenzel 2005).

The influence of the other in tax research is most commonly investigated in terms of the role of tax advisors, tax agents, or tax practitioners in “leading” taxpayers into and out of compliance, and of taxpayers demanding aggressive tactics from their agents, who then feel pressured into supplying riskier advice than they would otherwise give (see, e.g., Klepper and Nagin 1989; Klepper, Mazur, and Nagin 1991). Whereas most taxpayers want a tax advisor who is honest and will keep them out of trouble with the authorities, there is clearly a market in aggressive tax planning. High risk takers find tax advisors who specialize in aggressive advice and creative compliance, whereas cautious, no-fuss taxpayers find advisors who deliver a competent and honest service (Tan 1999; Karlinsky and Bankman 2002; Sakurai and V. Braithwaite 2003).
VIII. Procedural Justice and Dialogue for Effectiveness and Integrity of Tax Systems

In summary, the story of figure 15.1 is that a high integrity tax system is not only well-designed, but also is respectful of and responsive to the democratic will (V. Braithwaite 2003d). Three approaches to showing respect and responsiveness have empirical support in the scientific literature and have been used to guide policy decisions. The first approach is to treat taxpayers with procedural justice, manifested in taxpayers’ charters or bills of rights (see Organisation for Economic Co-operation and Development 2001b). The second approach is to listen to the public on matters relating to raising and spending taxes, illustrated through direct democracy referenda (e.g., in Switzerland), government reform (e.g., U.S. Tax Reform Act of 1986; see Scholz, McGraw, and Steenbergen 1992; Kinsey and Grasmick 1993), government task forces (e.g., Cash Economy Task Force; see Australian Taxation Office 1998), and best practice guidelines for tax administrations (Organisation for Economic Co-operation and Development 2001a). The third approach is to engage in dialogue with taxpayers, described by J. Braithwaite (2005) in the Australian context and Happé (2007) in the Dutch.

Research showing the importance of procedural justice for compliance with the law has been pioneered by Tyler and his colleagues (see Tyler’s 1990 seminal work). Procedural justice prioritizes dealing with people in a manner that is transparent, impartial, respectful, and inclusive of others’ interests and concerns. The important message from this work for tax research is that authorities develop trust and build their legitimacy, not through giving people the outcomes they want, which is often impossible, but rather through observing their right to a fair hearing and respectful treatment. Kristina Murphy’s (2003, 2004, 2005) work with Australians prosecuted for involvement in mass-marketed aggressive tax planning schemes has shown that concessions on penalties, though important, were less significant in fueling long-term anger and resistance than were perceptions of procedural injustice.

The importance of procedural justice is linked to another development: democratic deliberation and consultation (Dryzek 1990; V. Braithwaite 2003d). The democratic voice seems to have been lost (Commission on Taxation and Citizenship 2000), partly because of the complexity of tax systems (Picciotto 2007) and partly because of the common view that people don’t want to pay tax (Alm 1999) and therefore cannot deliberate on the matter constructively. Loss of hope that authorities will listen and consider different interests has been at the heart of much of the recent loss of legitimacy of governments (La Free 1998; V. Braithwaite 2004). Cutting the public out of deliberation about the rights and wrongs of tax evasion and avoidance may also be a key factor in escalating what many depict as a
cat-and-mouse game of law invention that leads eventually to loss of respect for law (McBarnet 2003). The research of Kinsey and Grasmick (1993) and Scholz, McGraw, and Steenbergen (1992) on the U.S. Tax Reform Act of 1986 provides evidence of how changes to the tax system can create a far better climate of compliance when the changes are championed through deliberative fora. Bruno Frey and his colleagues have shown that among the Swiss cantons, tax jurisdictions where direct democracy is practiced have higher compliance and, more generally, that deliberative processes and inclusiveness lower prospects of tax evasion (Pommerehne, Hart, and Frey 1994; Feld and Kirchgässner 2000; Frey and Feld 2001; Feld and Frey 2002, 2005; Frey 2003; Torgler, 2003). As well as being responsive to administrative capabilities, tax design needs the endorsement of the people.

The theoretical account that frames these findings is that when tax authorities and taxpayers have a psychological contract that communicates mutual respect, loyalty, and commitment to the deliberative process, the individual takes on the persona of a citizen who is engaged in the democratic process and accepts responsibility for contributing to the collective good (Feld and Frey 2007). The theory of motivational posturing shows that taxpayers slip in and out of this cooperative stance and demonstrates why tax authorities must work at keeping cooperation at the forefront in tax deliberations (V. Braithwaite 2003b; V. Braithwaite, Murphy, and Reinhart 2007).

These ideas are seen at work in contexts where tax authorities are in dispute with taxpayers. Happé (2007) has described the process of negotiation with corporations in the Netherlands, and John Braithwaite (2005) has described resolution of transfer pricing agreements in Australia in similar terms. The Compliance Model in figure 15.2 developed by the Australian Taxation Office (V. Braithwaite 2003a)
and now adapted to suit the needs of a number of other countries (Job, Stout, and Smith 2007) sets out a process whereby dialogue, persuasion, and mutual understanding proceed before the application of penalties. The application of the science of regulatory pyramids, as seen in the Compliance Model, recommends only as much intervention as is required to elicit compliance under the law. Commitment to respectful treatment and openness to cooperation exist at all times, but the pyramid threatens ever-increasing steps of regulatory intervention if evasion persists. A conversation can escalate into a warning, a warning into a wider conversation with stakeholders, conversations into sanctioning, and sanctioning into incapacitation at the pyramid’s peak. The use of the Compliance Model requires well-trained staff, tax officers who are technically and interpersonally skilled in dealing with irregularities and escalating sanctions where necessary. This can be a challenge for large bureaucratic tax administrations (Hobson 2003; Job and Honaker 2003; Job, Stout, and Smith 2007; Waller 2007). Pyramidal strategies can deliver an extra thousand dollars in revenue from each dollar spent on the strategy (J. Braithwaite 2005, p. 95).

**NOTE**

1. The audits conducted in the National Research Program (NRP) will detect a proportion of shadow economy activity but will not detect activity by individuals who are not connected in any way to the official economy. Estimates of the size of the cash economy vary with method, and differences between nations is great; estimates for the United States range from 6 to 14 percent of GNP (see Schneider and Enste 2002, pp. 29–42).

**IX. Conclusion**

Understanding and effectively managing tax evasion is a complex task, made more so when the objective is evidence-based policy making. Many different research perspectives have been offered for analyzing the problem, with the result that it is difficult for policy makers to tackle tax evasion in a systemic and holistic way. So how do we integrate what we know? Is there a framework for allowing these perspectives to coexist as policy is formulated? The wheel of social alignments (fig. 15.1) reminds us that although the system may be designed in accordance with normatively desirable principles and is expected to affect individuals in predictable ways, the effects may be other than expected. System designers have little control over meanings that individuals give to their experience and share with others, socially constructing narratives
that affect levels of cooperation and compliance with authority. Moreover, taxpayers can turn words of defiance into actions of defiance more readily in the twenty-first century because they have greater control over how they manage their tax affairs with support from a burgeoning global financial industry.

Tax authorities can no longer afford to design their systems as they please and ignore public perceptions. Nor is the answer bringing the community onboard through “spin,” which is a short-term approach to a serious problem. Tax authorities need to engage in a reflective process with the community about tax design, tax administration, tax benefits, moral obligation, coercion, justice, and alternative tax authorities. This discussion needs to be augmented by evidence acquired through field experiments and rigorous data analysis. Only then will tax authorities have the knowledge and moral authority required to manage the difficult problems of evasion and avoidance currently besetting tax systems.

REFERENCES


