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Tax compliance in a social setting: The influence of social norms, trust in government, and perceived fairness on taxpayer compliance

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ABSTRACT

Voluntary tax compliance is important for governments around the world as they try to manage budget deficits. Traditional methods to improve tax compliance, such as increased audits, can be costly to implement. The purpose of this study is to examine the influence that social factors have on individuals' tax compliance intentions. Results of a survey of 217 U.S. taxpayers found support for the influence of social factors on tax compliance. This research concludes that social norms influence compliance intentions indirectly through internalization as personal norms. Specifically, as the strength of social norms in favor of tax compliance increases, personal norms of tax compliance also increase, and this leads to a subsequent increase in compliance intentions. We also conclude that trust in government has a significant influence on both perceived fairness of the tax system and compliance decisions. This study adds to current tax research in two important ways. First, the results suggest that the influence of social norms on tax compliance is largely through internalization as personal norms. Second, to the best of our knowledge this is also the first tax compliance study in which perception of fairness is modeled as a function of trust rather than vice-versa. This research may help taxing authorities develop less costly and more effective strategies for increasing taxpayer compliance.

1. Introduction

Many tax systems around the world, including the U.S. income tax system, rely on voluntary compliance of taxpayers. Therefore, factors that influence taxpayer compliance are of interest to the Internal Revenue Service (IRS), policymakers, academics, tax practitioners, and the general public. The individual income tax is the greatest source of revenue for the U.S. Federal Government (IRS.gov, 2012b).[1] Given the recent economic downturn and the looming budget deficit, the federal government (and governments at all levels) is exploring opportunities to increase revenue by reducing tax evasion and increasing taxpayer compliance. Typical efforts include increasing detection risk, levying higher penalties on offenders, etc.; such efforts can be rather expensive. For instance, the IRS spends approximately $28 per tax return on administrative costs (Alm & Yunas, 2009). Despite such costly efforts, the revenue lost due to noncompliance is substantial. The most recent IRS estimate indicates that approximately $385 billion in tax revenues was lost in 2006 due to tax evasion (IRS.gov, 2012a). The need to reduce noncompliance in the face of shrinking enforcement budgets has forced the IRS and U.S. state departments of revenue to better identify factors that influence compliance decisions. Consequently, this study focused on a subset of such factors, namely social factors, and how they influence an individual's tax compliance decisions.

Early theories of tax compliance framed compliance as rational decisions based on expected utility (Allingham & Sandmo, 1972). Behavioral research in tax compliance continued to focus on similar factors while explaining the response in terms of framing (McCaffery & Baron, 2004) and accountability (Sanders, Reckers, & Iyer, 2008). However, other research has found that individuals' compliance decisions are influenced very strongly by social factors as well (Torgler, 2007). That is, taxpayers' compliance intentions are not shaped merely by economic considerations or perceptions of detection risk and severity of sanctions but also their personal norms. However, merely knowing that an individual's personal norm regarding taxation influences his/her compliance behavior does not help improve compliance. Instead, if one can understand how these norms are formed, then perhaps the antecedents of the norms can be affected or shaped in a manner that can impact compliance positively. Consequently, one purpose of the paper is to develop a model that identifies social norms as antecedents of personal norms and how these social norms impact compliance by being fully subsumed by personal norms.

The dominant theory in tax compliance literature is that perception of fairness in the tax system increases an individual's trust in government and consequently, has a positive influence on compliance.

[1] In 2010 gross collections in the U.S. from individual income taxes was $1,163,688 million, whereas gross collections from corporate income taxes was $277,937 million (IRS, 2012b).

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However, in this study we show that trust in government is an antecedent to perception of fairness; and trust influences compliance through the fairness construct. Consequently, another purpose of this paper is to develop a theoretical model that shows that trust is formed *before* fairness, individuals interpret the fairness of a system through the trust lens and subsequently form their compliance intention.

To achieve the two objectives stated above, in this study we developed and tested a comprehensive model of taxpayer compliance behavior that consisted of three major factors: norms, perceptions of tax system fairness, and trust in government. In addition, the model also consisted of three social norms as antecedents of personal norms. To the best of our knowledge this is the first comprehensive model that considers norms, trust and fairness in a single design.

This study found that compliance decisions are a result of many interrelated social factors. Specifically, social norms have an influence on compliance decisions, but only indirectly through internalization as personal norms. Trust in the government and perceived fairness of the tax system also have an interrelated influence on intended tax compliance such that perceived fairness of the tax system fully mediates the influence of trust in the government on compliance decisions.

This is an area where there has been a dearth of research. This understanding of how social factors simultaneously influence compliance with tax laws provides valuable insights on how compliance may be influenced and improved.

The remainder of this paper is organized as follows: the next section outlines the theory and hypothesis development. Data, and research design are described next followed by a presentation of results and analyses. The paper ends with a summary and our conclusions.

2. Background and hypothesis development

In recent years, voluntary tax compliance has been attributed to individual internal motivations to follow tax law, also termed as "tax morale." Tax morale encompasses several factors including social and personal norms, perceptions of fairness, trust in taxing authority, altruism, etc. (Kornhauser, 2007). In this study our goal was to identify social factors that policymakers may be able to take simple actions to influence. We focused on norms, trust in government, and perceived fairness of the tax system as determinants of tax compliance intentions.

2.1. Norms

Social psychology suggests that social interactions can have a significant impact on individuals' behavior. The influence of others is often manifested in the *social norms* of the group. *Social norms* are informal or formal rules of a group that guide the behavior and values of the group (Aronson, Wilson, & Akert, 2010; Cialdini & Trost, 1998). Kallgren, Reno, and Cialdini (2000) noted that norms are present in every social situation, even if their influence is not salient to members of the group. Therefore, social norms have important implications for behavior in any type of situation.

Since social norms are hypothesized to influence behavior in a variety of situations (Kallgren et al., 2000), they may also influence individuals' tax compliance decisions. Davis, Hecht, and Perkins (2003) modeled the determinants of tax compliance behavior and found that social norms,[2] along with enforcement and "others'" behavior, should influence compliance. Alm (1991) found that individuals who internalized a social norm[3] of compliance were more likely to comply. He also noted that individuals that believed others evaded taxes were more likely to evade themselves.

Using archival data, some studies have tested the theory that social norms influence compliance. Alm and Yunas (2009) examined the influence of social norms[4] by examining geographic compliance trends. The influence of social norms may be concentrated geographically since individuals in close proximity to each other are more likely to desire to be a part of the groups within their proximity. They found that geographic location, along with individuals' prior experiences, was a significant predictor of compliance.

Wenzel (2004) considered the influence of educational communications regarding sanctions on compliance. He found that the influence of sanction severity on compliance was moderated by social norms; severe sanctions were more effective at encouraging compliance when social norms favored compliance. This suggested that the public scrutiny threatened by evasion is only an effective deterrent if the social norms encourage compliance.

Prior research has typically considered norms as a single construct. However, social psychology research suggests that there are four different types of norms: (1) personal, (2) descriptive, (3) injunctive, and (4) subjective. These norms differ in their source and the influence they have on individuals' conformity to the group. While social norms are external influences on an individual's pre-disposition towards certain values, personal norms are the internal (hardwired) values. The relationship between social norms and personal norms is interesting because personal norms are likely influenced by social norms. In the tax compliance context, while internal (hardwired) values of an individual may be impossible to change, it may be possible to influence it via social norms.

2.1.1. Personal norms

Personal norms denote an individual's own moral standards and behavioral expectations (Cialdini & Trost, 1998; Wenzel, 2004). Personal norms may develop through internalization of the social norms of the groups an individual identifies with (Wenzel, 2004). That is, some of the most important social norms become part of the individuals' own moral standard. Since personal norms reflect an individual's own beliefs they should have a significant influence on all behavior including tax compliance behavior. Thus the first hypothesis is as follows:

H1. Personal norms of tax compliance have a positive effect on compliance intentions.

Although personal norms may have important implications for compliance decisions, they are difficult to directly influence because they are formed through internalization of experiences. Therefore, we consider the antecedents of personal norms, namely descriptive norms, injunctive norms, and subjective norms. These are the social norms that may influence the formation of personal norms and may also influence compliance decisions.[5]

2.1.2. Social norms

Descriptive social norms are perceptions of how other members of a group *actually* behave (Aronson et al., 2010). These norms influence the behavior of an individual within a social group. Descriptive norms are based on the actual actions of other members of a group and may sometimes conflict with behavior the group approves of (Aronson et al., 2010; Cialdini & Trost, 1998). These social norms provide information to help individuals guide their behavior in a variety of situations.[6]

Descriptive norms can encourage compliance with tax laws or evasion by helping individuals justify their actions. For instance, if

[2] In his analytical model, the concept of social norms was closely related to injunctive and subjective norms, and descriptive norms were captured in the behavior of others.

[3] This internalized social norm may be from descriptive, injunctive, or subjective norms, but Alm's (1991) study did not specifically identify nor study different types of norms.

[4] Alm and Yunas (2009) did not attempt to differentiate the influence of different types of social norms.

[5] Only one study (Bobek et al., 2007) examining the influence of each separate type of norm on tax compliance was found.

[6] Milgram et al. (1969) found that descriptive norms can entice individuals to engage in a behavior that they otherwise would not, such as staring aimlessly up at the sky simply because others stared aimlessly up at the sky.