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How income and tax rates provoke cheating – An experimental investigation of tax morale

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ABSTRACT

Anecdotal evidence suggests that tax morale diminishes with income and with levels of taxation. We designed an experiment that enables identification of causal effects. Subjects carry out a sequence of real effort tasks. The income earned varies with individual differences in effort (combined with variances related to skill or luck) and with the exogenously given length of the tasks. For each task, subjects privately roll a die, whose value determines the tax rate, which is then reported by subjects. This provides subjects with an incentive to cheat. Tax morale diminishes with higher effort, which might find ethical justification, but also with longer tasks, which would not. We implement treatments that vary the range of taxation. Contrary to widespread belief, participants' tax morale is invariant to these treatments. Our findings are best explained by a psychological force that tempts rich people to cheat more. This force does not seem to be related to fairness ideals that are prominent in theories of distributional justice nor to absolute levels of taxation.

1. Introduction

Does tax morale decrease with income? Do the rich have a higher tendency to evade taxes? This type of correlation is often suggested by media reports. Across the world, accusations of tax evasion are frequently raised with regards to prominent actors, businesspeople, sportspeople, senior politicians, or even heads of state.[1] Following the recent revelation of the widespread use of shell companies in Panama, the British Guardian and the New York Times inferred that the rich are not providing their fair share.[2] Henry (2016) estimates that 10–15 percent of global financial wealth is held unrecorded in or through

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[1] For example, just recently, international media headed by the German Der Spiegel reported that soccer superstar Cristiano Ronaldo falsely classified about 65 million € by using a shell company in the British Virgin Islands (see Der Spiegel 49/2016, "Die Dose des Ronaldo": 15–25).

[2] See Guardian April 8, 2016: "Panama Papers: a special investigation. Mossack Fonseca: inside the firm that helps the super-rich hide their money" retrieved online at https://www.theguardian.com/news/series/panama-papers and New York Times June 5, 2016 "Panama Papers Show How Rich United States Clients Hid Millions Abroad", retrieved online at http://www.nytimes.com/2016/06/06/us/panama-papers.html?_r=0.

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offshore havens, money that belongs to the top 0.1 percent and is kept out of the reach of tax authorities. But it remains uncertain whether such anecdotal evidence is indicative of low tax morale of the elite. For example, the correlation that we observe in the media might be driven by a selection bias. The media is more likely to report about big and prominent cases, neglecting the potentially more frequent minor cases of cheating by ordinary people.

There is widespread evidence for tax morale being of concern for taxpayers, who care for more than the probability of detection, the size of punishment or their reputation (Alm, McClelland, & Schulze, 1992; Andreoni, Erard, & Feinstein, 1998; Feld & Frey, 2002; Luttmer & Singhal, 2014; Slemrod, 2007; Torgler, 2002a). Taxpayers might seek to preserve a favourable self-image or have a sense of duty or responsibility. Do these types of intrinsic motivation deteriorate with income? Is there a psychological force that renders those with high income more willing to cheat?

Three types of fairness ideals are prominent in debates on distributional justice (Konow, 2000: 1073–4; Cappelen, Hole, Sørensen, & Tungodden, 2007; Cappelen, Moene, Sørensen, & Tungodden, 2013: 818). A libertarian ideal would favour giving people whatever they produced. Cheating on redistributive taxation might find justification by reference to such an ideal. Strict egalitarianism, on the other hand, would seek to balance any differences in income. Cheating on taxes might then find justification among those with a low income. One ideal in between these two extremes has been labelled liberal egalitarianism. This suggests that inequalities that result from variables that a person can influence, such as work effort or a risky choice, should be accepted, while inequalities should be avoided if they are due to factors beyond individual control, such as a physical handicap or an unlucky outcome. Diligent, hard-working people would then find ethical justification for deserving an income that is higher than that of others (Rawls, 1999: 89; Aldred, 2010; Konow, 2003: 79–112).

If those who earnt more feel they exerted more effort, they might thus rationalise cheating as a mean of resisting an unjustified redistribution of income. The opposite hypothesis would state that those with high income may behave more honestly. As put by Bertolt Brecht in the Threepenny Opera: "First comes a full stomach, then comes ethics." This hypothesis has been elaborated more thoroughly by Maslow (1970), who argued that basic physiological needs must be fulfilled prior to those related to self-fulfilment, with concern for welfare and moral standards belonging to the latter. Morale would then be a luxury good, requested more by the rich who have fully satisfied their basic needs. We investigate which of these opposing viewpoints finds support and whether tax morale is responsive to the above mentioned fairness ideals.

Our findings are important also for at least two further reasons. First, if tax evasion increases with income, taxation would fail to reduce inequality. Raising and redistributing more taxes would then be justified as a means of putting a higher nominal levy on those who evade more. Second, taxes paid by the elite may set the precedent for all other tax payers, thus being a central pillar of modern states (Everest-Phillips, 2010). This central pillar would be at risk if tax morale diminishes with income.

Apart from income, tax morale is likely to depend on levels of taxation. People with an egalitarian ideal are happy with redistributing a part of rich people's income. Others might regard redistributive taxes as an unjustified reduction in inequality, in particular, if taxes are high. In such a case, raising taxes might crowd out tax morale.[3] If this were true, the capacity of high tax rates to reduce inequality would find resistance among taxpayers and be crowded-out by an erosion of tax morale.

Investigating tax morale is notoriously difficult with observational data. First, tax compliance is not motivated by morale alone but also by the probability of detection, the size of punishment and concerns for reputation. These circumstances make it difficult to isolate the effect of tax morale on observed compliance. Second, people simultaneously determine their income and the level of compliance in response to a given tax rate. This renders it arduous to identify causal effects from tax rates and earned income on levels of compliance. We thus run a laboratory experiment that guarantees privacy to subjects and ensures that individual cheating cannot be detected so that compliance is motivated only by tax morale. Further, our variations of the tax rate affect tax morale but not income, which is earned prior to the determination of the tax rate in each round.

We find that higher income reduces tax morale. Higher income can result for participants who are more skilled in solving slider tasks or more attentive and lucky in hitting the target. In both cases we find that tax morale is reduced. This might correspond to the ideal of liberal egalitarianism, because higher income results partly due to variables that subjects can influence. Higher income can also result from longer tasks, which require increased effort from all participants. In this case tax morale also diminishes, which, we will argue, is not clearly related to fairness ideals. Our results also show that whether participants are placed into an environment with higher or lower taxation has no impact on their morale. But we find causal effects for tax morale to deteriorate the more unattractive a tax rate is relative to other tax rates within a given range. Our findings are best explained by a psychological force that tempts rich people to cheat more often, a force that is not responsive to distributional justice or to absolute levels of taxation.

2. Related literature

Many theoretical models (for example Allingham & Sandmo, 1972) depict the decision whether or not to evade taxes as a rational cost-benefit calculation regarding potential financial gains and the losses from being caught. While some studies

[3] For example, former US President Ronald Reagan claimed in his presidential campaign: "History shows that when the taxes of a nation approach about 20% of the people's income, there begins to be a lack of respect for government ……… When it reaches 25%, there comes an increase in lawlessness." (See Time Magazine 14 April 1980: "Where did he get those figures?", retrieved online at http://content.time.com/time/subscriber/article/0,33009,923950,00.html)