The Dynamics of Tax Compliance

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Abstract

The present article aims to analyse the relationships between a tax subject, a tax and the state that established it, from both an economic and a sociological point of view, by going beyond accounting, to understand the reasons for the various types of tax compliance and noncompliance. It contains an evaluation of the tax parameters the government has at its disposal and a discussion about the extent to which it can and should use them without violating natural law. It tries to subdue the scrupulously uncompromising conviction as to which side of tax evasion lies the injustice and takes into account information asymmetry, irrationality, anarchy, tax resistance and discontent in general with the social contract. It also argues regarding the paradoxes of concepts like taxes on negative externalities or choosing between proportional, progressive, regressive or lump-sum taxes, while considering productivity stimuli and the decreasing marginal utility of wealth. The exploration and examination of different lines of thought regarding taxation results in a personal approach to the ideologies on which tax systems that resonate with the material and cultural needs of a society should be based. After evaluating various options, this paper suggests implementing a single tax on the unimproved value of land, as suggested by Henry George, as leverage in dealing with tax noncompliance and with the many inconsistencies and inadequacies of present tax schemes.

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1. Introduction

As common sense suggests, there are several paths that can be taken in order to control the impact taxes have on society, some of which are, apparently, less winding than others. In order to analyse which of these are best it is important to make up our minds as to the manner in which they are to be judged. The American Institute of Certified Public Accountants (2005) has synthesised 10 indicators of good tax policy that work well as a starting
point for this discussion: 1. simplicity, 2. fairness, 3. economic growth and efficiency, 4. neutrality, 5. transparency, 6. minimizing noncompliance, 7. cost-effective collection, 8. impact on government revenues, 9. certainty and 10. payment convenience. Admittedly, the number 10 seems to have been chosen for its numerological value, as “economic growth and efficiency” and “neutrality” both imply the minimization of allocative inefficiency, and “impact on government revenues” and “certainty” are two sides of the same coin, the former being detailed as “The tax system should enable the government to determine how much tax revenue will likely be collected and when.” and the latter “The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.”. Let us call them both “quantifiability” (one being from the state’s point of view and the other from the taxpayer’s). Regardless of how fair a tax is, or of whether or not it is fair, there will always be those that are not willing to pay it, so I would add “enforceability” to this list of indicators. We will look at these to assess tax policies.

2. The problem

Firstly, most people would agree that paying taxes is part of honouring your side of the social contract which comes with benefits unlikely to be attained otherwise and that breaching the contract warrants punishment. Higher punishments or fines should lead to a drop in the number of people that consider tax evasion a risk worth taking and to an increased awareness of one’s fiscal obligations. But since it is impossible for the tax subject to return to the state of nature, being able only to choose – and, even that, to a slight extent – between social contracts, it is unjust to impose upon him any kind of obligation, insofar as he has not actually had any say in the matter. This realization alone is probably enough to spark resentment in most men, but add to it punishments considered disproportionate in regard to the offence (we have yet to decide if there even is an offence) and the feeling turns to anarchy. To quote the American Austrian School economist Mark Skousen:

“Taxation is the price we pay for failing to build a civilized society. The higher the tax level, the greater the failure. A centrally planned totalitarian state represents a complete defeat for the civilized world, while a totally voluntary society represents its ultimate success.” (Skousen, M. & Skousen, J.A., 1991)

However, supposing one would not be averse to adhering to a social contract, were he to be given a chance, and supposing there would be a way to evaluate what his option would be, were he to actually have it, deciding what the punishments should be would still be an issue. Since a tax is not only defined by the “who?”, “how much?”, “why?” and “how?”, but, also, by the “what if?” – as in “What happens if he doesn’t pay?”, we are forced to walk the fine line between the benefits of setting high fines, which are included in the benefit of the tax and populace’s ability to pay. For all punishments for all offences, including all fines, must, for the sake of justice, be in line with the tax fines that would come into effect, should the latter be raised. Since some of the acts deemed illegal by social contracts also come into conflict with what Thomas Hobbes (1651) would call “laws of nature”, therefore, being offenses by all standards, they warrant the highest punishments. Seeing how fair punishment implies proportionality in regard to the offense, the penalties for illegal tax noncompliance (as opposed to legal tax avoidance) must be significantly lower, even though that will affect their deterrence element.

Another obstacle in defining fairness is the conflict between the ability-to-pay theory and the benefit theory. Both theories are compatible with the principles of horizontal and vertical equity:

- People with the same ability to pay should pay the same amount (horizontal ability-to-pay equity).
- A tax subject with a higher ability to pay should pay a higher amount (vertical ability-to-pay equity).
- People who will reap the same benefits from the government’s planned use of the taxes they will eventually pay should pay the same amount (horizontal benefit equity).
- People who will reap larger benefits should pay more (vertical benefit equity).
The problem becomes apparent where public goods are involved. Due both to their diversity and to that of people’s circumstances, these principles are almost impossible to apply. But that aside, we still have to define the ability to pay, i.e., to make a mandatory “investment” suggested by the state. According to this paradigm, the tax subjects will be forced (fairly, mind you) to give up a certain amount of wealth and, indirectly, utility by way of equal sacrifice, equal proportional sacrifice, or equal marginal sacrifice.

A lump-sum tax entails an equal sacrifice of wealth, but it is regressive in the sense that the tax rate decreases as the tax base increases and, either way, it goes against vertical ability-to-pay equity. However, some would say that a tax that is regressive in terms of utility favours the enterprising and, therefore, economic development. On the other hand, introducing such a tax would set up barriers to entry, eventually leading to the appearance of oligopolies or monopolies and the excess burdens that come with imperfect competition. In short, one could also say that it would hurt economic development. A progressive tax respects vertical ability-to-pay equity, but it seriously hinders production. A proportional tax comes with a fixed tax rate and seems fair, while generating the smallest number of problems.

Whether the tax designer thinks in terms of wealth or utility makes a great deal of difference because of the diminishing marginal utility of all resources. Just as an example, let \( t \) denote a tax rate, \( W \) the wealth to be taxed and let utility be modelled after a logarithmic function, as it often is. Let us evaluate the loss of utility due to a non-lump-sum tax:

\[
\ln(W) - \ln(W - t_W \cdot W) = \ln(W) - \ln\left[W \cdot (1 - t_W)\right] = \ln(W) - \ln(W) - \ln(1 - t_W) = -\ln(1 - t_W), \quad \text{where:}
\]

\[
0 < t_W < 1
\]

The proportion of utility lost would be:

\[
P = \frac{-\ln(1 - t_W)}{\ln W}
\]

Suppose we have two subjects to be taxed proportionally or progressively and that one subject is better off than the other:

\[
0 < W_1 < W_2
\]

\[
0 < t_1 \leq t_2 < 1 \Rightarrow 0 < 1 - t_2 \leq 1 - t_1 < 1 \Rightarrow -\infty < \ln(1 - t_2) \leq \ln(1 - t_1) < 0 \Rightarrow 0 < -\ln(1 - t_1) \leq -\ln(1 - t_2) < +\infty
\]

If the tax were proportional \( t_1 = t_2 = t \) which would lead to:

\[
P_2 = \frac{-\ln(1 - t)}{\ln W_2} < P_1 = \frac{-\ln(1 - t)}{\ln W_1}
\]

We notice that a proportional tax in regard to wealth is a regressive tax in terms of utility, as the utility sacrifice is lower for the wealthier subject.

If the tax were progressive the following situation might arise:

\[
\begin{align*}
\ln(1 - t_2) &= x \cdot \ln(1 - t_1) \\
\ln W_2 &= y \cdot \ln W_1
\end{align*}
\]

\[
\begin{align*}
\Rightarrow P_2 &= \frac{-x \cdot \ln(1 - t_1)}{y \cdot \ln W_1} = \frac{x}{y} \cdot P_1 < P_1
\end{align*}
\]

It turns out that a tax can be, at the same time, progressive in regard to wealth and regressive in regard to utility. So what would be fair? Probably:

\[
P_{t_w,w} = \frac{-\ln(1 - t_w)}{\ln W} = k \forall 0 < t_w < 1, W > 0
\]
An approach often suggested as a solution to tax noncompliance and budgetary deficit is fiscal relaxation. Fewer people will find it impossible to pay their taxes. Fewer people will consider it worthwhile to avoid paying. It makes sense that, because of such a person’s nature, no-one law-abiding or with a submissive attitude towards society will engage in tax evasion, as the thing that qualifies him as law-abiding or submissive is his desire to pay. According to the US Internal Revenue Code section 7201:

“Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony […]”

In order for an act to qualify as tax evasion it must contain the element of “mens rea” (i.e., wilfulness). By definition, those who are law-abiding or submissive will not engage in acts of tax evasion. Therefore, the subset who were not able to pay a tax, but now are, will comply.

Lowering the fiscal burden would stimulate consumption both directly and by way of new investments which, in turn, would increase the number of tax subjects and the total tax base. The problem is that there is a certain latency between the triggering of a stimulating reform and the appearance of its tangible, positive results. The government would likely only consider such a reform when faced with social unrest that would make raising taxes a particularly risky course of action. But social unrest of such a magnitude is incompatible with economic harmony (budget surplus together with a thriving market). There is a high chance that things will get a lot worse before they get better and one might not have the time or the solvency to wait long enough.

3. A plausible solution

Another suggestion for improving a tax system was given by the American political economist Henry George who supported the replacement of all taxes with a single tax on the unimproved value of land. He claimed that, even more so than other natural resources, land should belong to all, equally, to use in the process of production which, unlike accumulation, is a driving force for progress. This land would be rented to those who put it to good enough use to make a profit.

“...The great cause of inequality in the distribution of wealth is inequality in the ownership of land. The ownership of land is the great fundamental fact which ultimately determines the social, the political, and consequently the intellectual and moral condition of a people. And it must be so. For land is the habitation of man, the storehouse upon which he must draw for all his needs, the material to which his labor must be applied for the supply of all his desires; for even the product of the sea cannot be taken, the light of the sun enjoyed, or any of the forces of nature utilized, without the use of land or its products. [...] Material progress cannot rid us of our dependence upon land; it can but add to the power of producing wealth from land; and hence, when land is monopolized, it might go on to infinity without increasing wages or improving the condition of those who have but their labor. It can but add to the value of land and the power which its possession gives.” (George, 1879)

Such a tax would come with several benefits:

- Abandoning multiple taxes in favour of a single one would reduce inefficiency in the collecting process.
- Land is a very easy to track possession, therefore pinpointing and quantifying tax liabilities would not be a problem. Tax evasion would be virtually impossible.
- It would work as a pigovian tax – named after English economist Arthur Cecil Pigou, the negative externality being the deadweight loss resulting from the hoarding of land without it being put to the best possible use. Unlike most pigovian taxes, this one would not cover an immoral activity that could be outlawed or faulty technology that could be improved, either by making use of the centralised collected funds or by giving entrepreneurs the financial incentive to improve it on their own, which, in time, would lead to the
disappearance of the tax. Nor would politicians need to pretend they plan to kill the hen with its first golden egg. This tax would be here to stay.

- The transition to such a system would not be a problem, considering that, as Henry George put it, “It is not necessary to confiscate land; it is only necessary to confiscate rent.” (George, 1879).
- If we consider the possibility of exempting surfaces just large enough for people to reside on in decent conditions, it would give them the option of turning down the social contract. That would mean, of course, that thereafter they would have to pay to enjoy any public service or improvement that has not restricted their access to a natural resource. But that is a slightly different matter.

4. Conclusion

Keeping in mind that order, progress and security are indispensable and, as all things, come at a cost (in this case, various personal freedoms) we need to attain them, while minimizing that cost. The French physiocrats argued that tax burdens are ultimately reflected in land expenses (costs/rents) and that a “laissez-faire” policy, particularly where taxation is concerned, would allow people to work mostly for their own benefit, harder, in agreement with the laws of nature and with no distaste for society. In other words, since taxes appear to be inevitable and land is inevitably taxed, let us stop there and avoid the form of government described in 1986 by U.S. President Ronald Reagan: “If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.”

References


