TAX NON-COMPLIANCE BEHAVIOR IN THE LIGHT OF TAX LAW COMPLEXITY AND THE RELATIONSHIP BETWEEN AUTHORITIES AND TAXPAYERS

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Abstract

The present study investigates tax non-compliance behavior under the influence of tax law complexity and the relationship between taxpayers and authorities. It is argued that the non-compliance is triggered by high complexity of tax law derived from excessive regulation, use of abstract and complex legal jargon, as well as constant changes of the Fiscal Code. Concerning the relationship between taxpayers and authorities, non-compliance is fostered by an antagonistic climate in which mutual distrust and the promotion of a "cops and robbers" attitude towards taxpayers prevail.

Keywords: tax behavior, tax complexity, non-compliance, authorities
JEL classification: G02; G28; H26

1. INTRODUCTION

Referring to taxation, Albert Einstein used to say “the hardest thing in the world to understand is the income tax”. Notwithstanding this opinion which might be shared by many taxpayers, the importance of taxes levied on income, capital gains or consumption in order to ensure the provision of public goods remains undisputed. Still, governments around the world register substantial losses due to tax non-compliance behavior.

Before tackling the issue of non-compliance, one first has to clarify what a compliant behavior is. According to the literature, tax compliance behavior encompasses simultaneously the following features (Franzoni, 1999, p.54): 1) true reporting of the tax base; 2)
correct computation of the liability; 3) timely filing of the return; 4) timely payment of the amounts due. In other words, compliance refers to following both the letter and the spirit of the law (James and Alley, 2002). Any deviations from the aforementioned features results in non-compliance behavior.

Referring to compliance, as assumed by the “slippery slope framework” (Kirchler et al., 2008), the quality of tax compliance differs when taking into account trust in authorities and power of authorities. On one hand, trust is a predictor for voluntary compliance, which is achieved without enforcement, based on taxpayers’ willingness to act in the interest of their peers and perform their duty as citizens in response to authorities’ trustworthiness. On the other hand, power is a predictor for enforced compliance, which is achieved through enforcement strategies (audits, penalties), based on taxpayers’ risk and penalty aversion.

By the same token, non-compliance also features two instances: tax avoidance and tax evasion. Although both instances generate the same result, i.e., nonpayment of tax liability due, there is a legal distinction between them in most of the countries. Tax avoidance implies using the loopholes of the law in order to reduce tax liability, thus being legal and respecting the letter of the law (Webley, 2004). In contrast, tax evasion comprises deliberate acts of breaking the law with the purpose of reducing taxes (Elffers et al., 1987). It involves acts of omission (e.g., not reporting certain revenues) or commission (e.g., falsely reporting personal expenses as business expenses), and it is liable to prosecution and fines (Kirchler, 2007, p.22) due to the fact that it disregards the letter and the spirit of the law.

From the manifold of factors which generate tax non-compliance behavior, the present study focuses on the tax law complexity and the relationship between taxpayers and authorities.

2. NON-COMPLIANCE BEHAVIOR UNDER THE INFLUENCE OF TAX LAW COMPLEXITY

2.1. General aspects concerning non-compliance behavior under tax law complexity

One of the factors which generate non-compliance behavior is the complexity and opacity of tax law. Apart from savvy taxpayers who manage to reduce their tax burden because they understand the law very well, many other taxpayers fail to comply because they understand the law very little. This is due to the fact that tax legislation is often unclear and creates many difficulties in interpreting it. As Slemrod et al. (2001, p.459) stated, “although one can assert that legality is the dividing line between evasion and avoidance, in practice the line is blurry; sometimes the law itself is unclear, sometimes it is clear but not known to the taxpayer, sometimes the law is clear but the administration effectively ignores a particular transaction activity”.

As one can assume, the complexity of tax law resides at the linguistics level. Generally, legislation texts contain specific legal jargon which is not easily understood even by certified tax advisors or financial experts, not to mention ordinary taxpayers. A very famous example concerning this matter dates from more than half a century ago. Researcher Günter Schmölders assessed economic knowledge of German politicians and members of the Bundestag finance committee and reached the conclusion they had “poor understanding of fiscal policy” (Kirchler, 2007, p.6). In the same vein, Moser analyzed in 1994 tax laws from the linguistics perspective and identified various problems which cause poor understanding of

According to James (1998, p.59), the difficulty found in reading tax literature in general and tax legislation in particular is called “fiscal fog” and it diminishes with the number of school years. Referring to the education needed for understanding properly tax laws, Lewis (1992) notices it is unusually high. Hence, in 1992, the British tax law required 13 school years while the average taxpayer had only 9 years of education, the US tax law 12 and a half years and the Australian tax law 17 years.

Numerous examples which emphasize the fiscal fog phenomenon are comprised in Ross Clark’s (2006) book “How to Label a Goat: The Silly Rules and Regulations that are Strangling Britain”. The title of the book is inspired after the “Sheep and Goats (Records, Identification and Movement) Order 2006, a document which regulates the size, shape and color of the ear tags applied to sheep and goats in Wales and is 45 pages long. Referring to the excessive regulation, Clark draws the attention towards the Government of Great Britain which in 2006 adopted 3.621 laws (on average 10 laws and regulations for each day of the year) spread over 72.400 pages and thousands of explanatory notes spread over 26.200 pages (James, 2008, p.4).

As a matter of fact, excessive regulation is an attribute of modern fiscal systems. Owens and Hamilton (2004) underline that one of the major problems of the countries belonging to the Organisation for Economic Co-operation and Development (OECD) is the excessive complexity of tax law and the difficulty in understanding and implementing it. After assessing the number of primary tax legislation, Cussons (2007) develops a ranking of the most regulated states, presented in the figure no.2.

Excessive regulation has many negative outcomes. Besides making compliance more difficult, it can open up loopholes into the law and give room to even higher tax avoidance, which is contrary to the interest of the state and honest taxpayers. Taking about this situation, the US senator Russell B. Long stated that a tax loophole is “something that benefits the other guy. If it benefits you, it is tax reform”. Tackling taxpayers tendency to slide down the “slippery slope” of non-compliance behavior and the reasons which trigger it, Walter (1984, p.52) cites a very critical opinion regarding the efforts of the American tax authorities to close loopholes: “…the weakness of [its] position is that members of the general public are increasingly dissatisfied with the state’s presumption that is has the right
to deprive the citizen of his wealth…[It] is quite clear that the avarice of the state in respect of its enormous claims on the private citizen’s wealth has been directly connected with the mismanagement of the U.S. public sector’s finances…public authorities cannot be trusted with the public’s money and …have an incurable tendency to squander it”. In order to avoid such harsh opinions, tax authorities must cast a critical eye on the legislation all the time and leave no room for interpretation.

In order to reduce the huge number of legislation pages, a practical solution would be the simplification. According to Cooper (1993), tax simplification has different meanings (James and Wallschutzky, 1997, p.448):

1. Predictability. A rule would be simple if that rule and its scope were easily and accurately understood by taxpayers and their advisers whenever necessary.
2. Proportionality. A rule would be simple if the complexity of the solution were no more reasonably necessary to achieve the intended aim.
3. Consistency. This would apply where a rule deals with similar issues in the same way and without the need to make arbitrary distinctions.
4. Compliance. A rule would be simple if it were easy for taxpayers to comply without incurring excessive costs.
5. Administration. A rule would be simple if it were easy for a revenue authority to administer.
6. Co-ordination. A rule would be simple if it fitted appropriately with the other tax rules; it would be complicated if its relationship with other rules were obscure.
7. Expression. A rule would be simple if it were clearly expressed.

Following the aforementioned directions, the tax law simplification process has to be performed very accurately, otherwise it will lead to even more number of legislation pages or it will create even more confusion. An example for the first inconvenient is given by the US congressman Delbert L. Latta who in 1985 stated: “I hold in my hand 1.379 pages of tax simplification” (Kirchler, 2007, p.8). For the second inconvenient, one apposite example is

**Figure no. 2. States with the highest number of pages concerning primary tax legislation**

<table>
<thead>
<tr>
<th>Country</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>9,000</td>
</tr>
<tr>
<td>Great Britain</td>
<td>8,300</td>
</tr>
<tr>
<td>Australia</td>
<td>7,750</td>
</tr>
<tr>
<td>Japan</td>
<td>7,750</td>
</tr>
<tr>
<td>USA</td>
<td>5,100</td>
</tr>
</tbody>
</table>

Source: [Cussons, 2007]
found in the Australian Good and Service Legislation (Kirchler, 2007, p.6): “For the purposes of making a declaration under this subdivision, the Commissioner may:

a) treat a particular event that actually happened as not having happened; and

b) treat a particular event that did not actually happen as having happened, and, if appropriate, treat the event as:

i) having happened at a particular time; and

ii) having involved particular action by a particular entity; and

c) treat a particular event that actually happened as:

i) having happened at a time different from the time it actually happened; or

ii) having involved particular action by a particular entity (whether or not the event actually involved any action by that entity)

One can see from the previous examples that simplification process is not as simple as its name would imply. Referring to the issue of using clear wording in the tax law, Lehmann (1995) quotes an Australian tax law which even though it uses plain English is quite ambiguous after the simplification process: “Your assessable income includes income according to ordinary concepts, which is called ordinary income” (James, 2008, p.7).

2.2. Non-compliance behavior under tax law complexity in Romania

Besides all the aspects mentioned in Section 2.1., non-compliant behavior displayed by Romanian taxpayers is also due to tax law complexity derived from the instability of legislation.

As it is generally accepted, legislation stability is one of the elements that ensures the development of the economic environment and insures economic growth. From this point of view, at least in theory Romanian tax law emphasizes this necessity integrating the issue of stability in the legislation text. According to the principle of taxation yield stated in article 3 of the Romanian Fiscal Code, regulations have to be applicable on long term in order not to disturb taxpayers’ activity. Moreover, as stated in the article 4 of the Fiscal-Budgetary Responsibility Law no. 69/2010, fiscal-budgetary policy is grounded on a series of principles, among which transparency and stability. Transparency principle emphasizes that the Government and local tax authorities have to disclose and publicly discuss during a reasonable period all information regarding the fiscal policy. Stability principle emphasizes that the Government has to implement the fiscal policy in order to ensure its predictability over long term and maintain macroeconomic stability.

Nevertheless, reality is contrary to legislation. The fiscal policy is unpredictable because the Fiscal Code changes several times during a fiscal year. Statistically speaking, during the last 7 years, the Romanian Fiscal Code was modified over 60 times through various laws, emergency ordinances and governmental decisions. The evolution of the number of changes in the Fiscal Code in the period 2005 - 2011 is presented in the graph no.1.

The high number of changes is in contradiction with the provisions of the article 4 of the Fiscal Code, according to which: 1) the Fiscal Code can be modified and adjusted only by a law which has to be made public 6 months before being adopted; 2) any change or adjustment in the text of the Fiscal Code becomes applicable starting with the first day of the next year and not in the same year it was adopted. According to many law specialists, many of the changes in the Romanian Fiscal Code were performed disregarding article 4. Besides the legal contradictions, the numerous changes created loopholes into the law based on which taxpayers decreased tax liabilities.
Considering tax legislation instability which eventually triggers the increase of distrust in tax authorities, taxpayers in Romania and especially those running a business can apply the following set of strategies: 1) continue the activity; 2) end the activity; 3) relocate the activity in countries with more stable tax legislation; 4) engage in tax avoidance or tax evasion. In the last years, a growing number of taxpayers adopted the last three strategies, thus diminishing significantly public revenues. Those who chose to continue the activity had to elaborate more business plans over a fiscal year in order to face changes in the Fiscal Code and not to be taken by surprise.

One of the Fiscal Code modifications that seriously affected public revenues and drove investors to other markets with more stable legislation and less bureaucracy was the introduction of quarterly tax returns on capital gains. According to this, starting with the 1st of July 2010, taxpayers investing in mutual funds and on the stock market have the obligation to fill in 5 tax returns each year regardless of their profit. Taking into consideration that financial markets are on a downward spiral at the moment, most of investors obtain insignificant or no profits from their activity.

In many situations taxes corresponding to these profits have an average value of 60 lei and a quarter of them register values of below 10 lei. Therefore, the expenditures generated by declaring and paying taxes on capital gains exceed the revenues obtained by the state at the end of this process.

As a first effect of the aforementioned modification, the number of new investors on the stock market decreased by 50%, and during the last three months of the year 2011 it decreased below 3,000. Compared to investors from EU members who benefit from less complex tax laws, investors in Romania have to fill in 5 tax returns corresponding to capital gains obtained on the internal market and only one tax return corresponding to the capital gain obtained abroad.

According to public finance experts, maintaining the quarterly tax returns which have already affected the number of investors will diminish even more public proceedings and the possibility of financing public deficit through the capital market. A more practical solution would be assisting investors by promoting an efficient tax system characterized by simplified legislation.
3. NON-COMPLIANCE BEHAVIOR AS A RESULT OF THE RELATIONSHIP BETWEEN AUTHORITIES AND TAXPAYERS

Based on the “slippery slope framework” (Kirchler et al., 2008), in the relationship between taxpayers and tax authorities two types of climate can emerge, an antagonistic climate and a synergistic one. In the antagonistic climate, tax authorities assume that taxpayers are rational maximizers willing to evade given the chance, therefore behave as “cops” and treat taxpayers as potential “robbers”. In turn, taxpayers feel persecuted and resent tax authorities, with many going the path of tax evasion. The antagonistic climate prevails of distrust and is ruled by the “enforcement paradigm” (Alm and Torgler, 2011), with tax evasion being deterred through frequent audits and harsh fines.

In the synergistic climate, mutual respect and trust prevails and tax authorities display a “service and client” attitude towards taxpayers. In turn, taxpayers are less likely to evade and voluntarily comply with tax legislation. The synergistic climate is accurately described by two new concepts called the “service paradigm” and “trust paradigm” (Alm and Torgler, 2011). The former stresses the role of tax authorities as facilitators and providers of customer-friendly services to taxpayers and the latter focuses on the role of ethics in compliance and the importance of changing the culture of paying taxes. According to Alm and Torgler (2011), many governments around the world have applied with success these paradigms. They single out the example of Singapore, a country which mainly uses electronic filing for tax returns and where tax authorities have shifted from the lowest rated public structure to one perceived as competent by 90% of taxpayers. Another example is the one of The Internal Revenue Service which has changed its attitude toward American taxpayers by using the “taxpayers don’t work for us, we work for them” approach (Gore and Rubin, 1998). James et al (2003) also reports a tendency for an increased focus on taxpayers in countries like the UK, France, Japan, Australia or New Zealand.

Climates can vary from an antagonistic to a synergistic one, depending on perceived levels of trust and power. When power increases, taxpayers may positively perceive it as an attempt of the state authorities to deter non-compliance, and hence they accrete the level of trust in authorities. As a consequence, the amount of tax payments grows and the tax climate becomes more synergistic. Nevertheless, taxpayers may perceive a raise in power as a sign of distrust and lose their trust in authorities. As a result, the amount of tax payments mitigates and the climate shifts from a synergistic to an antagonistic one. In the light of these facts, distinctions are to be made between legitimate power (voluntarily accepted by taxpayers due to its positive effects) and coercive power (rejected by taxpayers due to its enforcement effects) (Turner, 2005). Generally, an increase in power is perceived as coercive in an antagonistic climate, whereas in a synergistic climate this is perceived as legitimate. In a study on trust and power, Choudhury (2008) concludes that power diminishes trust when out-dated rules are applied and boosts trust when authorities act fairly according to the law.

In Romania, the relationship between taxpayers and tax authorities is characterized by antagonism and by the “cops and robbers” approach. As a consequence, taxpayers’ attitude towards tax authorities is a defensive one, with many of them displaying non-compliant behavior. As a result, the level of shadow economy reached in 2011 almost 40% of the GDP. The antagonistic climate is also amplified by the numerous errors made by tax authorities in detecting fraud in the wrong places. For example, in March 2012 several Romanian taxpayers were notified of being registered in the system as not having paid taxes for houses they
didn’t own. Other Romanian taxpayers stopped receiving welfare or other governmental subsidies due to allegedly unpaid fines, which in the end turned to be paid. The solutions that could be implemented in order to eliminate the abovementioned errors are making tax office employees more responsible in assessing taxpayers’ financial status and continuously improving the system used to calculate and register tax liabilities.

Thus, the nature of the relationship between taxpayers and tax authorities can engender non-compliance due to the use of excessive power or to internal errors. However, in the process of increasing compliance levels, tax authorities’ actions against non-compliant taxpayers could become more visible. The reason is very simple: if ordinary taxpayers see that non-compliant behavior is not tolerated by authorities who put considerable effort in closing loopholes and detecting tax offenders, they will perceive tax authorities as efficient and will also put considerable effort in paying their liabilities.

Taking into account the fact that tax compliance level in Romania is little above 70% (compared to the Scandinavian countries where it exceeds 95%), authorities’ visibility is essential in order to improve the current situation. As a former Ministry of Finance declared, every additional percentage of voluntary compliance is worth half a billion Euros. Romanian tax authorities organize such actions in order to fight tax evasion, but their effect is not always the expected one. As a proof, sanctioned entrepreneurs continue their activity in the same manner, willingly incurring the costs of paying high fines and having their merchandise seized rather than paying tax liabilities. Regardless of this, tax authorities have to continue surveillance actions on the ground that shopping areas-like investments are growing rapidly in Romania.

4. CONCLUSIONS

When tackling the issue of paying taxes for the provision of public goods, two main types of tax behavior emerge, compliance and non-compliance. Compliance behavior is displayed when taxpayers act according to the letter and the spirit of the law, paying taxes either because they consider it to be a civic duty, the right thing to do (voluntary compliance) or because they are risk averse (enforced compliance). Non-compliance behavior is displayed when taxpayers act against the letter and/or the spirit of the law thus engaging in tax avoidance and/or tax evasion.

Among the multitude of factors which cast an influence on non-compliance behavior the complexity of tax law is of paramount importance. Whether this comes under the form of excessive regulation spread on thousands of pages of tax legislation, use of abstruse legal jargon or redundant and excessively plain language, it is more than clear that tax complexity hinders taxpayers’ ability to comply easily and creates incentives to take the path down the slippery slope of non-compliance.

Another factor which fosters non-compliance is the nature of the relationship between taxpayers and tax authorities. As stated by the “slippery slope framework” (Kirchler et al., 2008) the synergistic climate is a predictor of tax compliance, while an antagonistic climate is a predictor for non-compliance behavior. Moreover, non-compliance behavior is also bolstered by the administrative errors done by tax authorities in their attempt to detect tax evaders.

In order to mitigate the negative effects of non-compliance behavior, tax authorities should take into account the impact of the two aforementioned factors, concentrate their at-
tention more on simplifying tax legislation, closing loopholes and insuring a climate of mutual trust by approaching taxpayers with a “service and client” attitude.

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Acknowledgements


References

Notes
1. In the expression “fiscal fog”, FOG is the acronym for “frequency of gobbledygook” (James, 1998, p.59).
2. The Australian Taxation Office was awarded the Plain English Campaign’s “Golden Bull” Award in 2007 for the use of ambiguous and confusing language in the text of the Goods and Services Legislation. The Plain English Campaign was initiated by Chrissie Maher in 1979 in Great Britain. For 33 years, the campaign has been fighting against “gobbledygook, jargon and misleading public information”. The Golden Bull Award is given each year to the worst examples of written English. Available at: <http://www.plainenglish.co.uk/awards.html> [Accessed 9 March 2012].
4. Romanian tax authorities organized several raids at Constanța harbor or the shopping areas near Bucharest which ended with applying high fines and confiscating merchandise without proper documentation.
5. An example of this kind is the shopping area “China Town” (Afungăți, Ilfov county), the largest of this kind in Europe, opened on the 19th of July 2011. According to the project, the area will cover a surface of 40 acres, will host 3.275 shops, 1.380 warehouses, coffee shops, restaurants, casinos, banks, kindergartens, and the total value of the investment controlled by Chinese entrepreneurs will reach 150 million Euros. In spite of the impressive investment, the opening of the business was marked by various problems. Two days after its grand opening, tax officers inspected the shopping area and after identifying many inconsistencies (lack of cash registers, forged documents for merchandise) they applied fines of 15.000 Euros. Available at: <http://media.imopedia.ro/stiri-imobiliare/china-town-incepe-pagubos-anaf-a-aplicat-amienzi-de-15-000-euro-in-complex17032.html> [Accessed 9 March 2012].