CHAPTER 3

LITERATURE REVIEW

Introduction

Research in taxation covers a broad spectrum of topics and research paradigms. Most tax research can be classified into one of three areas, although these areas are not mutually exclusive: tax policy, tax planning, and tax compliance research.

Tax policy research is generally concerned with assessing the effects and possible effectiveness of tax rule changes. Tax policy has several goals, such as (examples of tax rules for each goal given in parentheses): to raise revenue (income and sales taxes), to redistribute wealth (progressive tax rate schedules, earned income credit, and estate taxes), and to stimulate economic activity (accelerated depreciation schedules and tax credits). Given the stated goal for a tax rule, tax researchers can assess ex post how effective the tax rule is in achieving the stated goal.

The purpose of tax policy research is to provide information to inform policy makers of the results. It is descriptive rather than prescriptive (or normative).

The second major area of tax research is in the tax planning area. Tax planning research (for want of a better name) examines how firms and individuals respond to the tax rules. Alternatively stated: How do the tax rules influence how businesses and individuals conduct their lives? In some ways it is closely related to tax policy research (many of the same rules are examined), but the motivation behind the research, and the research questions themselves, are different. The researcher is less interested in the policy implications and more
in how firms respond to and are influenced by the tax rules. In each of these studies, the key research question is: How do taxes influence the choices studied.

Compliance research mostly employs the judgment and decision-making (JDM) paradigm, but also includes some analytical and archival-empirical studies. The research in this area is concerned with what factors determine compliance with the tax code. Some of the research questions addressed include what role do tax return preparers play in tax compliance, what role do IRS audits play, what role do penalties vs. education play in compliance, and what role does expertise/knowledge play in fact and issue recognition and in information search activities. The hypotheses in the JDM studies are generated from equity and prospect theory and more generally from the psychology field.

Shevlin T.,(1999), in a commentary on recent tax research in the US is of the view that all methodologies can be found in tax research: namely, experimental markets, behavioural/judgment and decision making, analytical, and archival empirical. As the recent past editor of The Journal of the American Taxation Association, JATA), Shevlin estimated that approximately 50 percent of the submissions employed archival empirical methods, 40 percent employed judgment and decision making, with the remaining 10 percent evenly spread between analytical and experimental markets approaches.

A deliberate omission from this list is legal research. The academic-based research journals (Journal of Accounting Research (JAR), The Accounting Review (TAR), Journal of Accounting and Economics (JAE), JATA, etc.) do not publish this type of research. Rather this research is published more in the law journals and practitioner-type journals.

This study examines penalties within the Self-assessment System. Penalties is just one of the many determinants associated with tax compliance.
Numerous determinants have been identified and classified as contributing to the level of compliance. These determinants will be briefly reviewed. However the focus will remain on the role of tax advisers and increased penalties on tax advisers. These studies can be relied on by policy makers to formulate tax policies to improve tax collection by increasing voluntary tax compliance.

It must also be pointed out that tax compliance research abounds in the United States than the rest of the world put together. However in Asia, which largely comprises of developing nations, no research on tax compliance behaviour has been reported in the established academic journals (Singh, 2000). In Malaysia only a handful of studies were published. The only known research on tax compliance are that on compliance costs (Loh, et.al. 1997); and tax evasion by Kasipillai (1997). This was observed by Singh, Veerinderjeet in a doctoral dissertation on Taxpayer Ethics, at University Putra Malaysia (2000), the results of which have not been published.

There has been a plethora of empirical findings on the behavioural pattern of taxpayers and tax professionals, but the understanding of compliance behaviour is still limited (Andreoni et. al., 1998;p855). Although numerous models have been propounded, it is not possible to model the actual tax compliance behaviour of taxpayers and no model can conceivably capture and incorporate the complexities of the human mind. In the US, the authorities, specifically the Internal Revenue Service, fund research on Tax Compliance. In Malaysia, while the Inland Revenue Board has its own Research and Development Division, little is published on its works as most of the work done is for internal use. The Tax Analysis Division of the Treasury, which is entrusted with tax policies, is also not known to publish the results of its studies. Statistics obtained from the Annual reports of the IRB do divulge much. It is usually confined to – percentage of returns not submitted, number of cases investigated and number of cases audited, (since the IRB commenced the field audit programme). Under these circumstances, researchers have to rely on the behavioural pattern observed in
other countries as a basis to explore further research and draw comparisons with the local scenario.

The concept – "determinants of tax compliance" is synonymous with the "determinants of non-compliance" or the question, "why people pay taxes?" or "why they do not pay?"

**Tax Compliance Research**

Tax compliance studies can be categorized by type of research: survey, experimental, analytical, or regression modelling.

A brief definition of 'tax compliance' will be appropriate at this juncture. Tax compliance can be defined as the timely filing or submission by taxpayers of all required tax returns, accurately reporting the tax liability in accordance with the tax law, and paying the tax due without the need for further enforcement by the tax agency. Non-compliance occurs when there is failure to file a tax return, when there is late payment of taxes, when there is an understatement of gross income and when there is an overstatement of deductions, exemptions, credits or rebates.

In the US, the Panel on Taxpayer Compliance Research defined compliance as follows:

"Compliance with reporting requirements means that the taxpayer files all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the Internal Revenue Code, regulations, and court decisions applicable at the time the return is filed". (Roth et. al, 1989:p 2)

In short, tax compliance or non-compliance is traditionally looked at from the following three angles:

- timely filing of returns
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- accurate reporting and
- timely payment.

Many factors influence the degree of voluntary compliance by taxpayers. These variables can be broadly categorized into three separate groups as follows:

(a) Willingness to comply:

- ethos of community, tax ethics, influence of associates/peers, perceived fairness of laws, individual psyche, real cost of compliance with the laws, how the government utilises tax revenue.

(b) Ability to comply:

- levels and types of education, tax literacy, experience (i.e. contact with the tax agency), certainty of tax laws, complexity (and ambiguity) of tax laws, availability and quality of assistance.

(c) Opportunity or options available for non-compliance:

- Complexity of the taxpayer's economic and tax law situation, sources of income, benefits of non-compliance, probability of detection, severity of sanctions, extent and status of taxes payable/refundable.

Theoretical Framework

Researchers have often utilised established theories in social behaviour to establish a more conceptual basis for conducting tax compliance research. Among them are expected utility, prospect theory, deterrence theory, cognitive structure theory, and agency theory and exchange theory.
Expected Utility Theory

An important explanation advanced on why taxpayers comply is that related to 'threat of detection and punishment'. This theory stems from the Economics -of- crime approach based upon traditional Expected Utility Theory and first applied to tax evasion by Allingham and Sandmo (1972). The basic model of Allingham and Sandmo has been extended in a variety of dimensions (see Yitzhaki, 1977; Pencavel, 1979; Sandmo, 1981; Cowell, 1985 and Alm, 1988).

According to this theory, a rational individual is viewed as weighing the expected utility of the benefits from successful tax evasion (or non-compliance) with the uncertain prospect of detection and punishment. Individuals pay taxes because they are afraid of being caught. Although it is clear that detection and punishment affect compliance to a degree (for empirical evidence on the different effect of that audit and penalty policies, see Dubin and Wilde, 1988), it is equally clear that these factors cannot completely explain tax compliance behaviour. Much of this research relies on the model of financial self-interest, derived from the economics -of-crime approach (Becker, 1968) and employing the assumptions of expected utility theory.

The first piece of work that developed a theoretical framework for explaining criminal activity was that by Becker (1968). According to Becker, an individual will commit a crime if the expected utility to be gained from committing the crime exceeds the utility to be gained from engaging in the alternative legitimate activity. In essence, Becker's model is a time allocation model concerned with the allocation of time between legal and illegal activities.

Prospect Theory

The earliest economic model of tax evasion assumed that people treat evasion as a simple gamble (Allingham and Sandmo, 1972; Srinivasan,
1973; Weiss, 1976). However, prospect theory modifies expected utility theory. It posits that individuals make different decisions depending on how choices are framed. The formulation of the problem and the norms, habits, and personal characteristics of the decision-maker control the frame that the decision-maker adopts (Tversky and Kahneman, 1981).

According to prospect theory, people make choices in two stages: problem-editing and evaluation. In the problem-editing stage, options are reformulated to simplify subsequent choices. During this process, outcomes are framed as gains or losses relative to some reference point. In the evaluation phase, the individual evaluates the outcomes and chooses the one with the highest value. Outcomes are viewed as positive or negative in relation to a reference outcome that is judged neutral (usually assigned a value of 0). The reference outcome is often set by social norms and expectations. The reference outcome is frequently correspondent to a level of aspiration. Whether an outcome is viewed as a gain or loss may depend on variations of the reference point (Tversky and Kahneman, 1981).

The major studies using prospect theory as a theoretical frame are Friedland et.al (1978), Friedland (1982), Chang et.al (1987), Klepper and Nagin (1989) and Robben et. al (1990)

As an illustration, Robben et. al.'s (1990) study conducted a business simulation to investigate the role of decision frames and opportunity in tax evasion. The study was based on Kahneman and Tversky's prospect theory. The business simulation was used because the authors felt that in previous studies where subjects were given income and information about tax rates and audit frequency, the subjects had a clear idea of what the experimenter wanted (hypothesis guessing). The authors concluded that greater opportunity leads to greater tax evasion and that their study lends support to prospect theory.
Yaniv, G. (1999)

A Prospect Theory analysis was utilised to study tax compliance behaviour in a framework of advance tax payments. While obligatory advance tax payments do not interfere with the taxpayer's evasion decision under expected utility theory, they do affect the decision to evade under prospect theory. According to the Expected Utility theory, a rational individual is viewed as weighing the expected utility of the benefits from successful tax evasion (or non-compliance) with the uncertain prospect of detection and punishment.

The study applies prospect theory to a simple model of tax evasion, exploring the role that advance tax payments may play in enforcing tax laws. The study demonstrates, as empirically found in the US, that advance tax payments may substitute for costly detection efforts in enhancing compliance. However, contrary to a recent claim in the tax evasion literature, deliberate high advance tax payments are unlikely to eliminate the incentives for non-compliance.

In a recent contribution, Elffers and Hessing (EH, 1997) suggest, following Robben (1991) and Webley et al. (1991), that prospect theory, developed by Kahneman and Tversky (1979), may help explain taxpayers' observed behaviour under obligatory advance tax payments. Elffers and Hessing argue that when prepaid taxes are greater than the true tax liability, the taxpayer expects a gain from filing a return, whereas if prepaid taxes are less than the true tax liability, they expect a loss. Hence, in the spirit of prospect theory, the taxpayer is risk averse with respect to the former case and risk seeking with respect to the latter. Consequently, he will opt to avoid risk in the former case and to take his chances in the latter. They conclude that the incentives for non-compliance can be eliminated if the tax authorities deliberately set the advance payments slightly above taxpayers' true tax liability so as to ensure a gain from filing a return.
Yaniv's study appears to disproof the above findings in the earlier literature. Why should a skilful evader, who is aware of the low probability of getting caught and punished for tax evasion (which is less than one percent in the United States), switch to safety when subjected to an advance payment that is slightly (or even significantly) higher than his true tax liability? Just because he is manipulated to play in the risk-aversion domain? Intuitively, it may be possible that prospect theory supports the finding that compliance increases as the advance payment is raised above the true tax liability and decreases as the advance payment is lowered below the true tax liability, but to find out whether this is so, as well as whether advance tax payments may effectively eliminate the incentive for non-compliance, requires a more rigorous application of prospect theory to the tax evasion problem than the qualitative considerations pointed out by EH.

This study applies prospect theory to a simple model of tax evasion with the purpose of inquiring into the taxpayer's decision of whether and to what extent to underreport their taxable income if obliged to pay a tax advance prior to the filing of a tax return. While the tax advance is in part determined by the taxpayer's tax rate and estimated taxable income and in part by the taxpayer's choice (as some tax systems allow taxpayers a certain degree of flexibility as regards their prepaid amount), it may also include an exogenous component, permitted to the tax authorities by a variety of policy options. Allowing for such a component, the study subsequently inquires into the implied trade-offs between advance payments and conventional enforcement in enhancing compliance. The study, however, abstracts from taxpayers' own discretion in the determination of the prepaid amount, because this implies that taxpayers may have control over whether they owe taxes or have taxes due at the time of filing, rather than view their tax balance at that time as exogenously given. Hence, the application of prospect theory to analysing the relationships between tax compliance
and advance payments, which rests on the assumption that potential tax evaders think primarily in terms of out-of-pocket gains and losses at the time of filing, may not be appropriate.

**Deterrence Theory**

Deterrence theory posits that taxpayers consider the benefits and drawbacks of non-compliance in view of the higher probability of detection and the severity of punishment for non-compliance. In particular, the theory assumes that people conform out of fear of negative sanctions that may arise for failure to comply with legal inscriptions and shared social norms. Sanctions can take three forms: (1) formal or legal sanctions from failure to comply with the directives of the State i.e. the threat of legal punishment; (2) informal or social sanctions from failure to comply with norms attributed to the social group i.e. the threat of social disapproval; and (3) self-imposed sanctions or feelings of guilt from failure to comply with internalized norms i.e. moral conscience (Grasmick and Green, 1980).

Grasmick and Green (1980) found that each of these mechanisms has a significant, independent effect on inhibiting illegal behaviour. Grasmick and Green’s finding suggests that an effective deterrence programme will contain one or more of these mechanisms.

In the tax compliance area, the tax authority/agency has traditionally relied on legal sanction (civil and criminal penalties) as the primary deterrent to evasion. Prior research has found that to be an effective deterrent, legal sanctions must be communicated (Grasmick and Green, 1980) and perceived as enforced (e.g., Klepper and Nagin, 1989). An alternative philosophy involves the use of positive communication approaches to (1) encourage an existing sense of moral obligation to pay taxes, or (2) develop perceptions of a moral obligation (e.g., Hite, 1989; Smith, 1993).
Deterrence theory investigates the manner in which the number of deviant acts is reduced. Deterrence is most often accomplished through the threat of punishment. Individuals with varying perspectives on the law, morality, and the threat of punishment itself will react differently to the threat of punishment (Silberman, 1976).

A sanction threat, in the case of tax evasion, is a warning that penalties, property seizure, or imprisonment may result from non-compliance. Sanction threats may: (1) lead to prevention of a particular deviant act (compliance); (2) reduce the frequency of the deviant act (lead to less frequent non-compliance); (3) change the way in which the deviant act is done (taxpayer may search for another means of non-compliance); (4) have no effect; or (5) lead to more deviance (increase non-compliance). Sanction threats operate through fear (wishing to avoid unpleasant consequences such as fines and imprisonment; moral or normative reinforcement (strengthening moral inhibitions, clarifying rules, creating habits of conformity); and motivational diffusion (stimulating associates or potential offenders to encourage the individual to seek non-deviant means of achieving goals) (Title, 1980).

If a taxpayer anticipates a penalty that is probable enough and severe enough to outweigh the financial benefit of non-compliance, that taxpayer will likely comply with the tax laws. A taxpayer’s perceived cost of non-compliance is influenced by the taxpayers’ perception of detection risk and the magnitude of the related penalty. Sanctions are a necessary element to motivate compliance for the majority of taxpayers. (Jackson and Jones, 1985).

The threat of economic sanctions has traditionally been used to influence the tax reporting decisions of both taxpayers and paid tax preparers in the US. The penalties and reporting requirements faced by preparers have increased significantly in recent years and continue to be the subject of much debate. The
case, of Malaysia, “the ball has started rolling”. There is little evidence, however, that such penalties influence the recommendation of tax advisers.


**Tittle (1980)**

Since most prior research on the effect of sanctions was not empirically based, Charles Tittle conducted a study to determine what effect sanctions actually have on human behaviour. He surveyed 1,993 people from three states in the US concerning individual perceptions of the probability of being caught and punished for a variety of deviant acts (including tax evasion) and then related those perceptions to individual self-reports of deviant conduct and inclinations.

The salient conclusions drawn from the study includes:

1. fear of sanctions has a deterrent effect but may not be as important as moral commitment and affiliation with deviant influences;
2. fear of informal sanctions more effectively deters deviant behaviour than fear of formal sanctions;
3. informal sanctions are only effective if they are perceived to be certain, while legal sanctions are only effective when perceived to be very severe; and
4. type of offence did not appear to be an important variable.
The study also examined six demographic variables: gender, age, race, social status, marital status, and labour force status. Only age and gender were found to be reliable predictors of deviant behaviour.

**Scott and Grasmick (1981)**

A deterrence model based on motivational and inhibitory variables of behaviour was used in this study. The postulation of such a model was thought to be necessary because prior research had not included perceptions of rewards in the research designs and had therefore underestimated the deterrent effects of sanctions.

To test their model, they collected data for model estimation from 329 randomly selected taxpayers living in the Oklahoma City metropolitan area. The independent variables were: (1) perceived injustice in the taxpayers' exchange with the government, and three inhibitory variables, (2) guilt, (3) stigma, and (4) legal punishment. The variables were measured on a 4-point Likert-type scale. The dependent variable, cheating, was measured by asking the respondents how many times in the past five years they had failed to report all income or claimed undeserved deductions. Scott and Grasmick found that when perceptions of sanctions do not have a strong effect on behaviour, then individuals are not motivated to cheat. However, perceptions of sanctions have strong inverse effects on tax cheating when individuals are motivated to cheat. They also found that when inhibition is high, motivation to cheat has little influence on tax cheating.

**Grasmick and Scott (1982)**

Grasmick and Scott conducted a study to investigate whether three types of punishment (legal sanctions, social stigma or guilt feelings) had the same magnitude of inhibitory effect on tax evasion and the different types of theft (i.e.
petty or grand theft). The study used survey data obtained from personal interviews of 401 adults in a metropolitan area. Legal sanctions were measured by asking if the individuals felt they would be apprehended. Social stigma was measured by asking how many of the five people you know best have evaded taxes, or been involved in petty or grand theft. Guilt feelings were measured on a five-point Likert type scale. The respondents were asked if they felt committing one of the acts was always, usually, sometime, seldom, or never wrong. Responses to the items measuring perceived punishment threats were then dichotomised.

Grasmick and Scott found that 61% of the respondents felt tax evasion was always wrong, 63.6% said their friends had evaded tax, and 37.9% believed they would be caught. The bivariate relationships (chi square test for high/low inhibition) was significant for all three perceived punishment threats. The three threats of punishment accounted for 31% of the variation in tax evasion.

Grasmick and Scott stated that their threat of guilt feelings was comparable to Schwartz and Orleans' (1967) conscience appeal. When examining intent to evade or steal in the future, the threat of guilt feelings had the greatest inhibitory effect on tax evasion. All three punishments were of equal or greater effectiveness in deterring tax evasion than theft.

**Cuccia (1994)**

In this study, a preparer model is developed that predicts that the threat of economic sanctions should affect (1) the aggressiveness of recommendations made by preparers when faced with ambiguous issues and (2) the effort investe4d by preparers in identifying taxpayers' unambiguous reporting positions. Client expectations and role perceptions held across preparer groups, however, are expected to moderate the impact of economic sanctions.
To test the model, commercial tax preparers and CPAs were given an interactive tax preparation task. The model’s predictions related to preparer effort were supported for both preparer types. When exposed to a strict liability penalty, commercial tax preparers invested less effort in identifying tax-reporting items that were expected to increase the exposure to the penalty. CPAs, however, increased their effort level. The penalty threat had limited effect on the aggressiveness of recommendations regarding ambiguous issues. The results suggest that increased economic sanctions may affect the effort invested by paid preparers in identifying legitimate ways of reducing their client’s tax liability while having little effect on how aggressively they interpret ambiguous issues. The results provide evidence of a “backlash” effect of increasing sanctions on paid tax preparers that is contrary to the goals of tax lawmakers and administrators. Penalty threats resulted in CPAs recommending significantly more aggressive positions.

Exchange Theory

Individuals pay taxes voluntarily because they value the goods and services provided by the government and they recognize that their payment may be necessary to set others to contribute. The exchange element is represented by a taxpayer’s satisfaction or lack thereof with his terms of trade with the government. This covers a variety of matters including a taxpayer’s perception of his tax burden in relation to others, the amount of tax he pays relative to benefits received, his perceptions of how wisely the government spends taxpayers’ money and the taxpayer’s general attitude to private versus public spending.

Evasion or compliance is attributable to both economic and socio-psychological factors and these two factors can be seen as complementary rather than diametrically opposed. In order for governments to combat tax evasion or promote compliance, they should implement policies and programmes
covering both economic and psychological responses (Hasseldine and Bebbington, 1991).

Psychological models generally suggest that attitudes and beliefs are the basis of human behaviour. So, intuitively, in order to curtail evasion and non-compliance, existing negative attitudes and beliefs of taxpayers should be altered or modified. The changing of attitudes and beliefs can be achieved through programmes that provide taxpayers with information which persuades them to pay taxes, and increases their belief that their taxes and being put to good use and that their contribution is very important to the country's development. Researchers and tax administrators agree that through education, taxpayer service, and positive advertising, governments can change taxpayers' perceptions regarding the fairness of the tax system, and modify their negative attitudes toward the tax collecting agency.

The Role of Tax Professionals in Tax Compliance

Relatively a small body of work has focused upon tax advisers. Due to the complexity of the tax law, most taxpayers cannot interpret or apply the law to their own returns. One service that tax practitioners can provide is to assist in the interpretations of the tax laws and rules and to aid taxpayers in computing the least amount of tax they legally owe. In addition, practitioners have a duty to the tax system to prepare accurate returns that are supported by the tax law. When these two duties are in conflict, the US Treasury Department contends that the prevailing obligation of preparers is to the tax system (Shapiro 1987). Continually changing tax laws and an increasingly complex tax system lead many taxpayers to seek tax assistance (Christensen, 1992).

Although Jackson and Milliron (1986) did not identify Preparers or Tax Advisers as one of the fourteen major compliance variable, it was however included among the miscellaneous variables. In the US, since over 40 percent of
all individuals taxpayers use professional preparers [Department of Treasury, 1985, p.850] the influence of these preparers is considered as a potentially important compliance variable. However, it is not known to what extent tax advisers may foster compliance or non-compliance, nor to what extent recent tax preparer and taxpayer penalties may impact the role of the preparer (Jackson & Milliron, 1986). Although a few preparers who dealt with lower income taxpayers reported that they were viewed as government agents, [Westat 1980a, p.81] reported that most preparers believed that they are viewed by their clients as advocates. Consistent with this view of preparers as advocates, analysis of tax return data by the IRS shows more audit adjustments to paid preparers than self-prepared returns, regardless of the type of return.

A related finding, using an experimental approach, suggests that preparers employed by CPA firms in the US take or advise more aggressive positions than those employed by other types of preparers [Ayres and Jackson, 1985]. This result is to be expected because of the higher degree of training provided to CPA firm employees in general. There is a greater capacity to develop and defend aggressive positions in "grey areas." It is interesting to compare the foregoing results with survey results showing that respondents who reported self-preparation returns were significantly more likely to admit non-compliance than those who reported use of a preparer [Westat, 1980, p 60]

The role of the professional in tax compliance has drawn comment from the academic community as well as from professionals and revenue authorities themselves. Interest is focussed mainly on the two-way relationship between taxpayer and the adviser and the adviser and the government. Because of this relationship, professionals may experience conflict in deciding what is in the best interest of the client and what is in the public interest (Tooley 1992 p.2).

There is evidence in the literature, which suggests that tax professionals or their clients account for a fair proportion of non-compliance. Klepper and
Nagin (1989, p.167) report that in 1979 in the United States, 44% of all tax returns were prepared by paid preparers and yet these returns accounted for 74% of all non-compliance. Their results suggest that preparers contribute to compliance by enforcing legally clear requirements and contribute to non-compliance by taking advantage of ambiguous requirements. This is an indication that preparers represent both a means of increasing compliance and also potentially a threat to compliance. Erard (1993) reports that in Canada they are directly responsible for preparing nearly one-half of all individual returns.

It is argued (Erard, 1993) that existing literature on tax practitioners has two primary shortcomings: (1) the models generally do not distinguish among tax preparer types, and (2) there is a lack of evidence from micro-level date on the relationship between tax preparation mode and tax compliance.

**Klepper & Nagin (1989)**

Their findings suggest that preparers play a mixed role in the compliance process. On the one hand they appear to contribute to non-compliance by helping taxpayers take advantage of ambiguous features of the tax code. On the other hand, they appear to contribute to compliance by enforcing legally unambiguous features of the tax code and by acting as important conduits for communicating tax agency enforcement priorities.

The results suggest that preparers represent both a means of increasing compliance and also potentially a threat to compliance. In light of this, public policy must be carefully structured to exploit the pro-compliance effects of preparers. Yet this would seem to require much greater knowledge about the effects of preparers on compliance and the reasons taxpayers engage preparers.
Reckers et. al (1991)

Tax practitioners are viewed by the government as contributing to taxpayer non-compliance in the United States. Congress has tried to influence their behaviour through the use of preparer penalties. Prior research, based on opinions and beliefs of practitioners, has indicated that preparer penalties may not be effective in altering practitioners' behaviour. This research empirically tests whether preparer penalties influence the aggressiveness of CPAs when (1) giving advice to a client, and (2) signing a client’s return. This research also examines the impact of client compensation on the aggressiveness of CPA’s. The results indicated that a higher level of present and future compensation received from a client doesn’t increase the aggressiveness of CPA’s when giving advice or signing returns. Preparer penalties were found to be effective in reducing CPAs aggressiveness for only signing returns.

The findings that preparer penalties encouraged more conservative behaviour on the part of the subjects is not consistent with most prior research. Prior research (Schnee et. al. 1987; Jackson et.al, 1988; Miliron and Toy 1988) has found that tax practitioners consider preparer penalties to be very serious, but they believe that these penalties are, for the most part, ineffective in altering their behaviour. It was hypothesized that the threat of preparer penalties causes tax professionals to be more conservative in the tax positions recommended to clients and reduces their willingness to sign returns in which a questionable position has been taken. The results indicated that preparer penalties would be ineffective in altering practitioners’ behaviour. The findings were based on practitioners’ perceptions about penalties rather than behavioural experiments.

The current trend in the US is towards increased preparer penalties and restriction of preparers’ latitudes in tax law interpretations. The present research suggests that increased penalties may prove to be effective in improving compliance provided that the sanctions are not idle threats. In order for sanctions
to be effective deterrents tax practitioners must be aware of their existence. A plausible explanation for the differences in the effectiveness of penalties found by this study, is that tax professionals are less aware of the penalties applicable to tax advice and more aware of tax return preparation penalties.

As noted by Hite and McGill (1992), past compliance studies have failed to consider the impact of the preparer on the compliance decisions, Hite and McGill (1992) and Collins et al. (1990) found that taxpayers want preparers to assume an enforcer role. Collins et al. found approximately 70 percent of taxpayers surveyed used preparers to file an accurate return, but only 25% of the sample indicated that minimising taxes was their primary goal. Likewise, Hite and McGill found taxpayers tend to agree with the conservative advice from a preparer but disagree with aggressive advice.

Scotchmer (1989) asserts that preparers resolve taxpayer uncertainty by arriving at the "true" taxable income. This assertion is consistent with Collins et al. (1990) and fits with Klepper et al.'s (1991) view of the preparer as an enforcer of the tax law.

Both Ayres et al (1989) and Kaplan et al (1988) found aggressive positions to be common among tax preparers. Ayres et al (1989) indicated that CPA preparers tended to be more aggressive than non-CPA preparers on cases involving tax deductions. Kaplan et al. found practitioners with favourable IRS experience to be significantly more aggressive than other practitioners. The findings of Christian et al (1994) support these findings. Christian et al. found that paid-prepared returns have both a lower overall tax burden through reduced liabilities as well as lower prepayments. Schisler (1994) found preparers to adhere to the aggressive/conservative tendencies of the client. Schisler's research indicated that preparers may neither be exploiters nor enforcers, but rather the degree of the preparers' aggressiveness is client dependent.
Hume et al. (1999)

To assist CPAs who prepare tax returns, the AICPA issued a series of statements reflecting appropriate standards of tax practice. These Statements on Responsibilities in Tax Practice (SRTPs) consider a CPA's responsibilities to clients, the public, the government, and the profession. Unlike the Code of Professions Conduct which applies to all CPAs, the SRTPs specifically address the problems inherent in a tax practitioner's dual role as advisor to clients and attester to the government.

In this study the effect of the SRTPs in resolving ethical issues was examined. The findings suggest that a clear majority of CPAs follow the SRTPs when making ethical decisions relating to tax return preparation and that CPAs follow the SRTPs more often than unlicensed preparers on half the issues tested. However, a statistically significant number of CPAs do not follow the SRTPs and CPAs do not follow the SRTPs any more often than unlicensed tax preparers on three issues.

Failure to follow the SRTPs can lead to lower levels of compliance. The researchers recommend that increasing the number of CPA preparers who follow the SRTPs when confronted with ethical dilemmas enhances the profession's reputation and should be encouraged.

Cruz et al. (2000)

The CPA clearly has a responsibility to avoid advocating fraudulent positions or positions without merit. However, as a client's tax position moves along the continuum from merely aggressive to clearly fraudulent, it is not always obvious at what point the CPA should abandon advocacy and insist on less aggressive reporting.
Several studies have investigated tax practitioners' willingness to advocate client positions that are aggressive or in the "grey" area. This research has identified a number of factors that potentially influence preparers' aggressiveness, e.g., preparers’ attitudes toward risk (Carnes et al., 1996), the threat of preparer penalties (Reckers et al., 1991), and client risk preferences (Schisler 1994). However, these studies have generally not addressed the ethical considerations that influence advocacy judgments. A recent study by Burns and Kiecker (1995) represented the first attempt to explicitly investigate tax practitioners' ethical judgments.

The IRS, AICPA, and American Bar Association (ABA) have adopted the "realistic possibility" standard, which states that practitioners should not advocate a client's tax return position unless they believe it has a realistic possibility of being sustained on its merits if challenged. However, due to the complexity and uncertainty surrounding many tax issues, it is often difficult to judge if this standard has been met. This difficulty, when combined with client pressure for aggressive reporting, creates a complex professional judgment involving both technical and ethical considerations. This is an issue that has been identified as the most difficult ethical/moral problem facing public accounting practitioners.

In this research, professional tax practitioners' ethical judgements and behavioural intentions were studied in cases involving client pressure to adopt aggressive reporting positions. To obtain insight into the ethical considerations that influence such judgments, the multidimensional ethics scale (MES) developed by Reidenbach and Robin (1990, 1988) and refined by Cohen et al. (1996, 1995a, 1993) was used. Use of this scale is based on the premise that individuals use more than one rationale in making moral judgments, and that the significance of these rationales differs among problem situations. The MES was used to measure the extent to which a
hypothetical behaviour was consistent with five ethical philosophies (moral equity, contractualism, utilitarianism, relativism and egoism).

Responses from a sample of 67 tax professionals supported the existence of all dimensions of the MES other than egoism. Regressions of ethical judgements and behavioural intentions on the MES dimensions indicate that ethical decision-making is most heavily influenced by the moral equity dimension, followed by the contractualism dimension. In contrast, the utilitarianism and relativism dimensions were only related to ethical judgements and behavioural intentions in isolated instances.

Determinants of Tax Compliance

Various factors have been identified as contributing to the level of compliance or non-compliance. Researchers have classified these into various headings. These factors may be broadly classified into three groups, namely

- economic factors,
- administrative and legal determinants and
- psychological attitudes

Han Geroms and Hendrik Wilmots (1985) differentiate the causes of tax evasion and tax avoidance. In their view tax avoidance is purely determined by economic variables and tax evasion is mainly determined by socio-psychological and economic variables. However it must be realized that these factors do not act on their own, but reinforce each other in motivating taxpayers to avoid or evade taxes. An introduction to these determinants is best examined before exploring the various theories propounded to explain this compliance behaviour. The above mentioned three groupings will now be examined.
a. Economic Factors

In general, the economic models to explain decision to evade taxes depict tax evasion as a profit maximizing or utility maximizing activity. Allingham and Sandmo (1972) aptly described evasion as a special form of gambling for extra income. The taxpayer is viewed as a rational being who would choose a level of evasion, which would maximise the expected savings, or gains, minimize the expected costs and thus maximise his after-tax income. Expected savings or gains amount to the tax evaded in the light of the probability of non-detection. Expected cost, on the other hand, refers to the expected fines and penalties in the light of the likelihood of detection.

Cross and Shaw (1982) state that tax avoidance is completely determined by cost and revenue. The revenue consists of the taxes that can be saved and is indicated by the marginal tax rate. The cost consists of the compensation for fiscal experts and/or the opportunity cost for the time spent by the tax avoider himself in figuring out different ways of tax avoidance. It can also be stated that the more productive a person is, (i.e. the greater his knowledge of fiscal laws), the larger his production, i.e. his tax avoidance.

Spicer (1986), advances an additional cost, the psychic cost which may arise from guilt feelings from breaking a commitment to the social norm of compliance and desire to avoid risk.

b. Administrative and Legal Determinants

Administrative determinants refer to the efficiency of tax administration while legal determinants refer to the adequacy of the tax structure. The legal framework of the tax system also determines substantially the level of tax evasion. It has been noted that the tax laws themselves contain the seeds of their own avoidance. Inadequate or defective statutory provisions may increase
opportunities for tax evasion. This has long been cited in various studies and discussion as a contributory factor. Alm, Bahl and Murray (1990) cited that the decision to comply or not to comply with the tax laws depends fundamentally upon the incentive introduced by the tax system and according to Plasschaert (1962), evasion can only occur where evasion opportunities exist. One of the weaknesses of tax legislation which contribute to tax evasion is the complexity of the legislation (Madeo, et.al., 1987).

It has been said that half of the compliance process depends on the taxpayer’s awareness of his responsibility and his knowledge of the compliance process. Complexity of the tax laws deters people from fully understanding their responsibilities and the procedures for compliance. In extreme cases, even tax enforcers are confused by such complexity causing incomplete, improper or conflicting application of the tax laws. Other possible inadequacies of the tax laws are absence or leniency of penalties for evaders, excessive tax exemptions and allowable deductions and inability to effectively define total taxable income (SGATAR, 1987).

c. Psychological Attitudes

The new field of fiscal psychology evolved from the recognition that understanding compliance transcends economic, legal and administrative determinants. Fiscal psychologists acknowledge that evasion is a behaviour determined by the interaction of various forces: economic, social, political, cultural and psychological. The general attitudinal and behavioural orientation of taxpayers towards accurate tax compliance has been referred to as tax ethics (Vogel 1974). The taxpayer’s predisposition is shaped by the interaction of the following factors:
(i) **Aspirations and perception of equity and the rationalization of government spending policies.**

Aspiration has been defined as the attitude towards the burden and distribution of taxes and the level of government services provided (Vogel 1974). The taxpayer-government relationship has been described as an exchange relationship where the taxpayer forgoes some of his purchasing power in return for some material and non-material benefits from the government (Spicer 1980). For a participant in an exchange relationship, a lack of equity between his or her own terms of trade creates a sense of distress.

An unfortunate aspect of a tax system is that because of varying objectives, it is discriminatory by nature. (Porcano,1984). Traditional equity theorists indicate two types of equity within a tax system: horizontal equity and vertical equity. Horizontal equity requires people in equal circumstances to be treated in an equal way. Vertical equity requires an appropriate differentiation among unequals; that is those who can afford to should pay a greater percentage of the tax. A progressive tax rate structure is supposed to produce vertical equity, but given the various loopholes and other objectives, it does not achieve as much equity as expected.

Equity theory is described as having effects in two directions (Spicer and Becker, 1980). First, if taxpayers perceive themselves as victims of inequity, they may seek to reduce that inequity by adjusting their inputs or contributions. Second, if the perceived equity is to their advantage, it is suggested that they might be less likely to increase the inequity by practising tax evasion. In short, this theory states that when a taxpayer feels that the government expenditure does not meet his expectation, and benefits are lacking with respect to the taxes he pays, then the propensity to evade tax will be higher.

Taxpayers would seem especially susceptible to a feeling of lack of equity since they do not directly participate in establishing the terms of trade, which are
established by the legislature. Empirical evidence from social psychology shows that in an inequitable relationship, a participant may seek to restore equity by adjusting the inputs or contributions to the exchange (Walter, et.al., 1973). Perception of inequity in his terms of trade is said to tilt against the taxpayers’ favour at a higher level of income where marginal tax rates are high and availment of public services is low. Taxpayers also perceive inequity in terms of unequal opportunities for evasion where higher income taxpayers are at advantage. (Spice, et.al., 1976).

(ii) Social Orientation

Social orientation has been used to refer to attitudes influenced by the taxpayers’ social background and knowledge of the tax system (Vogel, 1974). Dornstein(1976) suggests that orientation of taxpayers are shaped by a number of factors, among which are their past and present socio-cultural experiences, their ideological predisposition towards the State and their experience in dealing with bureaucratic and governmental institutions. In Sweden, for example the government has long been identified with the interest of the working class( Vogel, 1974). It was expected that the blue-collar workers would support the tax system more strongly than the other groups. Political inclination to a large extent also influences taxpayers’ attitudes towards compliance. Supporters of the opposition would more likely resent the tax system and be more strongly predisposed toward evasion.

Past surveys also revealed that taxpayers require more information than provided by tax forms or returns. Those who did not consult other sources of information showed significant misunderstanding and inaccuracies in their return (Vogel, 1974). These are generally taxpayers in the lower socio-economic groups who are less able to take advantage of tax minimization opportunities, because they are less exposed to tax compliance information, less informed about relevant tax regulations and less knowledgeable on return preparation.
(iii) Perception of Opportunities for Evasion, the likelihood of Detection and the Applicable Fines and Penalties.

A taxpayer would be less prone to evade taxes if he perceives that there are fewer opportunities for evasion, the probability of detection is high and the sanctions are severe (Vogel, 1974). Opportunities for evasion are perceived to be greater for those who are self-employed, who have additional income not subject to withholding tax and who are of higher educational levels. It has also been noted that non-compliance is positively co-related to the taxpayers' knowledge of other people practicing evasion. Conversely, the taxpayer's awareness of evaders being caught and prosecuted as well as the probability of tax audits deter them from taking their liabilities for granted. Perceived penalties are not only confined to those proved by law. Fear of informal sanctions and public disclosure are among the most powerful motives for compliance. These arise from the pressure of peers and the community and from the anxiety of getting caught.

Key Tax Compliance Variables

The factors affecting compliance can be analytically categorised and enumerated in many different ways. In studying tax compliance, Smith and Kinsey (1985) have found it useful to identify five sets of factors:

- Lack of opportunity for non-compliance
- Minimal cost of compliance,
- Knowledge and ability to comply
- Normative commitment to obey the laws, and
- Desire to avoid formal sanctions for non-compliance
Opportunity

One reason why many people comply as fully as they do is that they have little opportunity not to comply. Taxpayers whose only income consists of wages and salaries subject to withholding have few opportunities to under-report income. Opportunity is such a strong constraint on behaviour that it should be a major focus of attention in examination programs. However, there will always be some opportunities for non-compliance, and examination needs to address those factors which bolster compliance even in the face of high opportunity.

Low Cost

The lower the cost of compliance (in terms of money, time, effort, and emotions) the greater will be the compliance, other things being equal. Low costs, particularly low psychological cost, also help reinforce the normative commitment to comply, or at least reduce the justifications for non-compliance. Tax administrators can do a great deal to help minimize both the monetary and psychological costs of compliance.

Knowledge and Ability

It is not possible to comply with a regulation if one does not have the information and skills necessary for compliance. Tax laws are often complex with ambiguous interpretations, and they require accounting and arithmetic skills, which some people may not have. Compliance can be increased by maximising the clarity of tax regulations and assisting people with record keeping and simplifying the accounting and arithmetic tasks they must perform.

Of course, reducing the level of required knowledge and ability will also reduce the costs of compliance.
Chapter 3: Literature Review

Changes in tax laws and regulations undercut accumulated knowledge and habits, so there should also be a concern with stability and predictability. Tax laws and regulations cannot be static in a complex and changing society, but more attention needs to be paid to the transition costs of changing tax regulations and their impact on non-compliance.

Normative Commitment

Most individuals guide their behaviour according to their system of ethics, their beliefs about what is right and what is wrong. Also, other people, particularly friends and relatives, often have expectations about how one should act in a given situation. Most people want to receive the approbation of these “significant others” and avoid their disapproval. These norms of behaviour are not necessarily consistent with those mandated by formal rules and regulations and may even contradict them.

Social norms may also vary from group to group, both in terms of what is prescribed and proscribed and in terms of the strength of the normative obligation. If the norms about certain behaviour are strong, they can be an overriding determinant of that behaviour. Therefore, (strategies/procedures) will be most effective in the long run if they are designed to weaken norms against compliance and to strengthen norms that encourage voluntary compliance.

Avoidance of Formal Sanctions

Finally, people conform to regulations in order to avoid being detected and punished by the formal authorities. Three aspects of formal sanctions are important in deterring non-compliance: the likelihood of detection, the severity of punishment if detected, and the swiftness of detection and punishment. An obvious, but often ignored, point is that people will consciously avoid formal sanctions only if they know about them: perception of the probability, severity,
and swiftness of sanctions are in many respects what count the most. This cuts both ways: people can perceive formal sanctions as being either stronger or weaker than they actually are.

**IRS Classification of Compliance Variables**

The American Internal Revenue Service has detailed 64 potential compliance factors. In addition to common compliance related variables such as income and age, the list includes home ownership, intergenerational mobility characteristics (suggesting that taxpayers who have the same socio-economic background as their parents are more compliant than those who are upwardly or downwardly mobile), and mental health (IRS 1978).

Jackson and Miliron (1986) identified 14 major variables and several miscellaneous ones in a listing of 43 compliance studies. They then proceeded on a survey of these variables. These variables are:

- Age
- Income Level
- Compliant peers
- IRS Contact
- Sanctions
- Race
- Ethics
- Informal Sanctions
- Social Orientation
- Prevalence of Evasion
- Gender
- Withholding income source
- Occupation (status)
- Probability of Detection
- Trust in Government
- Party affiliation
- Marriage
- Financial Needs
- Information Precision
- Satisfaction with financial situation
- Education
- Fairness
- Complexity
- Tax Rates
- Religion
- Knowledge
- Tax Adviser
- IRS Services

Some of the more common variables mentioned above are discussed here briefly:
Age

A common variable of interest in the studies surveyed is the chronological age of the taxpayer. For both US and foreign studies, the most prevalent finding reported in the literature is that older taxpayers are more compliant. Young taxpayers are more willing to take risks and are less sensitive to sanctions and also reflect social and psychological differences attributable to the period in which they were raised. Although a positive link between age and compliance was frequently reported, several researchers found no significant relationship between these two variables. The lack of significant results is at times attributed to difficulty in getting a cross-section of the age group, i.e. range restriction. While age may be positively related to non-compliance, it might be related to another variable for example - and it might hold the key to non-compliance (e.g. high marginal tax rates) (Wallschutzky, 1993). Despite the potential importance of the age variable in affecting future levels of compliance, and despite repeated testing of this variable, the impact of age on compliance is still uncertain.

Gender

The majority of studies testing the compliance level of males versus females have found males less compliant. Traditionally, females have been identified with conforming roles, moral restraints, and more conservative life patterns, all of which would tend to promote tax compliance. However, Grasmik, Finley, and Glaser [1984] offer empirical evidence that indicated that a new generation of independent, non-traditional women may be closing the compliance gap between men and women with regard to economic offences such as tax evasion.

There may also be some interaction between sex and the compliance variable “probability of detection”. Richards and Tittle (1981) note the women’s perception of arrest likelihood for tax evasion is significantly higher than men’s.
Income Level

The findings on income level are mixed. A confounding factor is the correlation between income level and tax rates. Not only are researchers about evenly divided on whether income level is a significant compliance variable but those who assert that it is a significant variable are about evenly divided on whether low or high income taxpayers are less compliant. Still other researchers (e.g. Mason and Lowry (1981), and Witte and Woodbury (1985) have concluded that middle income taxpayers are most compliant and that both low and high income level taxpayers are relatively noncompliant in comparison. Under a progressive rate structure such as exists in the United States, higher level taxpayers realize a greater dollar return by evading, but this return may have less economic utility.

Frank and Dekeyser Meulders's (1977) study of Belgian taxpayers found that the propensity to evade varied according to income level, income source and occupation. Only high income professionals apparently had the opportunity to practice extensive evasion in the Belgian system. These findings may apply to the compliance situation in the US in that both low and high income taxpayers may derive more of their income from sources not subject to information reporting and thus have greater opportunity for evasion than middle income taxpayers subject to withholding on their wages.

Income Source

Income source refers to the type or nature of the income item. Early studies in the 50s have indicated the significant influence of income source on tax compliance. The IRS has recognised the importance of this line of research by annually computing voluntary reporting ratios for different types of income items. Conclusively, the IRS data show that income subject to withholding, and to
a lesser extent, income subject to information reporting, have the highest compliance ratios [IRS, 1983].

In a survey of Australian taxpayers by Wallischutzy [1984a,p.38], it was found that both evaders and non evaders agreed that the greatest opportunity to evade tax exists with those who derive their livelihood from self-employment, independent trade, or farming, and the least opportunity exists for those whose source of income is dependent on wages or salaries subject to withholding.

According to the Wall Street Journal (WSJ) [1984, 19 November p. 34], income source has also been identified as an important compliance variable in Japan and Italy. One reported estimate for Japan is that; on average, salaried employees pay tax on 90 percent of their income, while self-employed business people and professionals report only about 60% and farmers about 40%. In Italy, evasion of the self-employed is evidenced by the fact that in 1983, shopkeepers declared average annual income equivalent to $3,579 less than their shop assistants [WSJ, 19 Nov.].

**Occupation**

Occupation, generally defined as an individual's employment or earnings activity, has been posited as a compliance factor for over 40 years. Initially tax evasion was considered a white-collar crime, committed by a person of respectability and high social status in the course of his occupation [Sutherland, 1949,p9]. Originally the tax laws applied only to relatively affluent citizens, since generous allowances exempted most of the working class. Now that the income tax laws cover a broad spectrum of income levels and occupations, the association between tax compliance and occupation is no longer obvious.

Mason and Calvin [1978, p. 82], in a study of 800 taxpayers, found occupational prestige significantly related only to type of non compliance, that of
failure to file, but not to the underreporting of income or the overstatement of deductions. However, Westat [1980b, p.55], in a study of 500 taxpayers, found that employment in manufacturing or trade organization was associated with higher self-reported tax compliance and that the occupational categories of professional/managerial, clerical/sales, and service employees were associated with lower levels of compliance. The European studies generally have taken a different approach, with mixed success, using occupation as part of a surrogate for socio-economic status (in conjunction with education and income).

**Peer Influence**

Peers can be loosely defined as taxpayer’s associates. These associates may be reasonably expected to include friends, relatives, acquaintances, and co-workers. Further, those peers who influence the taxpayer are more likely to be those held in esteem by the taxpayer. Deterrence theory, as elucidated by Tittle [1980] and Grasmick and Scott[1982], and reference theory, as explained by Spicer and Lundstedt [1976], both posit that if a taxpayer knows many people in groups important to him who evade taxes, then his commitment to tax compliance will be weaker.

Taxpayers’ evasion intentions are influenced significantly by their perception of the extent of evasion by others who may not be known personally, but who are perceived to have high moral character (Kaplan and Reckers, 1985), and by studies showing higher rates of evasion when the taxpayer’s community and peer groups are non-compliant [Vogel, 1974; Geerken and Gove, 1975; Witte and Woodbury, 1985].

**Ethics**

Taxpayer ethics is a nebulous concept to define. Ethics are generally understood to describe moral principles or values held by individuals. Song and
Yarbrough [1978] apply this notion to define tax ethics as “the norms of behaviour governing citizens as taxpayers in their relationship with the government”. In this regard, Westat [1980, pp37-45] found moral concerns about tax compliance relatively weak. Taxpayers were generally ambivalent about whether tax cheating, especially when small amounts are involved, is morally wrong. In addition, if a position could be justified by some interpretation of the rules, even though likely to be disallowed by the IRS, the majority of taxpayers interviewed felt an aggressive position was morally defensible. Any advance in research on tax ethics appears to be critically dependent on the definition of ethics employed. Song and Yarbrough [1978] concluded that the overall tax ethics of the taxpayers they surveyed were only “barely passing” (60.3. on a scale of 100).

Tax evasion occurs not simply because some taxpayers have opportunities to evade tax. It also requires a desire or motivation on the part of taxpayers to exploit those opportunities. Furthermore, in a democratic system, the taxpayer’s perception, evaluation and compliance with tax laws are equally important (Song & Yarbrough, 1978).

Fairness

Tax fairness seems to involve at least two different dimensions. One dimension appears to involve the equity of the trade—the benefits received for the tax dollars given. The other dimension appears to involve the equity of the taxpayer’s burden in reference to that of other individuals (i.e taxpayers’ perceptions of the horizontal and vertical equity of the tax system). An experimental study (Porcano, 1984) designed to determine perception of a fair and equitable tax structure and redistributions indicated that the second dimension may be the more salient feature. In this study by varying hypothetical needs, paying abilities, and equality considerations, in addition to benefits received from exchange with the government, it was found that taxpayer need
and ability to pay were the most significant variables related to perceptions of a fair system.

It is not clear to what extent fairness perceptions may affect compliance, although evidence abounds that taxpayers, have serious reservations about the fairness of their tax systems (Westat, 1980). However, large scale compliance surveys such as those conducted by Mason and Calvin [1978 and 1984] and Yankelovich, Skelly, and White [1984] have failed to find any significant link between attitudes regarding the fairness of the tax system and self-reported tax behaviour.

An important unknown in the research finding fairness to be a significant variable is whether a feeling of inequity increases the propensity to evade or is a rationalisation for evasion.

**Complexity /Ambiguity**

As the tax law has grown increasingly complex, complexity has come to be recognized as a possible compliance factor. Complexity does influence tax-reporting positions. Testing four hypothetical tax cases, Milliron (1985) found that complexity had a significant effect on reporting position in each case, but that the directional impact was mixed because of interactions with two other compliance factors (perception of fairness and opportunity for evasion).

Taking a different approach, Long and Swingen (1985) used tax preparers to empirically derive a definition of complexity. They found that two factors, excessive detail in the law and the numerous computations required, accounted for 86 percent of the variation in their subjects' complexity scores. Westat (1980) theorized that complexity aggravates taxpayer uncertainty, which, in turn, acts to deter compliance.
Spilker et.al. (1999)

This study addressed three primary issues. First, it examines whether tax professionals interpret tax law ambiguity to the benefit of the client in compliance decision contexts. In contrast to prior studies, this study approached the issue by directly manipulating the level of ambiguity within a single tax scenario.

Secondly this study compares how tax professionals respond to tax rule ambiguity in compliance vs planning decision contexts. Professionals are likely to consider their vulnerability to certain risks (e.g., damage to professional reputation, risk of not retaining the client and risk of litigation) in deciding whether to make an aggressive recommendation in the presence of ambiguous tax rules. They argue that tax professionals will likely be able to shift more of this risk to the client in compliance than in planning decision contexts. A likely response to mitigate an increase in perceived risk due to the nature of the decision context is to make a more conservative recommendation. Thus, this study investigates whether the risks inherent in planning contexts will mitigate tax professionals' propensity to act aggressively in the client’s interest.

Third, this study considers how tax professionals respond to differing levels of rule ambiguity in planning decision contexts. Precise rules may facilitate tax planning by reducing the uncertainty surrounding the ultimate resolution of issues. On the other hand, ambiguous rules may frustrate tax planning by increasing uncertainty surrounding the requirements for reaching desirable reporting positions.

The data were collected in an experiment with a group of 63 tax professionals consisting of partners, senior managers, and managers from three of the former Big 6 public accounting firms. In the experiment, rule form (precise
or ambiguous) and decision context (compliance or planning) were manipulated between subjects.

The results are generally consistent with their hypotheses and can be summarized as follows. First, as compared to a relatively unambiguous baseline condition, subjects in the compliance decision context interpreted an ambiguous tax rule to the benefit of the client, even though the position can be considered as being very aggressive.

Second, subjects receiving the ambiguous tax rule in the planning decision context were less likely to recommend the aggressive tax position than were subjects receiving the same ambiguous tax rule in the compliance decision context, even though planning subjects were able to create a more favourable client fact pattern. In fact, planning/ambiguous subjects' recommendations did not differ from the baseline compliance/unambiguous condition, in which justifying the client-favourable position appeared to be very difficult. These results are consistent with the additional finding that tax professionals in the planning decision context perceived the client-preferred reporting position as more abusive of the intent of the ambiguous tax rule than did professionals in the compliance decision context.

Finally, tax professionals exploited tax rules to a greater extent than ambiguous rules to achieve client-preferred outcomes in a planning decision context, suggesting that tax professionals utilize tax law precision to support aggressive, client-preferred positions in planning contexts. This result should be of interest to tax policy makers who must make decisions on the level of rule ambiguity to incorporate into new tax laws. Overall, their results suggest an interesting dilemma for tax policy makers. To the extent policy makers write ambiguous tax rules, they may be successful at frustrating tax planning opportunities, but this advantage may come at the cost of allowing more aggressive reporting positions in compliance decision contexts.
Krauze, Kate (2000)

When laws are complex or ambiguous, compliance and enforcement suffer. In the United States, the federal income tax is a familiar example of this. Often, neither the taxpayer nor the Internal Revenue Service (IRS) can perfectly determine a taxpayer's true tax liability. Uncertainty, ignorance, and burdensome documentation requirements deter some taxpayers from taking advantage of legitimate deductions and credits, whereas others find opportunities for creative tax avoidance in ambiguous provisions. Complexity undermines the IRS's ability to distinguish among intentional evasion, honest misinterpretation of the tax code, and legitimate tax avoidance. This model shows that the IRS cannot always profitably exploit complexity.

It will be of little avail to the people that the laws are made by men of their own choice if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is today, can guess what it will be tomorrow. The responses to complexity can undermine the policy goals that originally led to complexity. In addition, they affect the ability of the IRS to collect revenue.

Non-compliance with complicated rules like tax laws differs from other crimes in several important ways. First, compliance is not merely a matter of refraining from criminal activity. An imperfect return may be unintentional, arising out of misinterpretation of the rules or unintentional acts of omission. Second, the distinction between compliance and non-compliance is not always clear, and in many instances, the IRS and taxpayers will genuinely disagree. Scotchmer (1989) addresses unintentional non-compliance, suggesting that uninformed taxpayers will both underpay and overpay taxes.
Complexity itself is not a policy tool but an unavoidable cost of refining the tax system to accurately reflect ability to pay and of using the tax system to influence behaviour or to redistribute resources. Although these complications lead to greater tax code complexity, they also enhance equity and reduce distortional behaviour. Complexity affects the IRS enforcement strategy by increasing audit costs and reducing audit accuracy.

There are valid policy reasons for many complicating features of the federal income tax code. The tax system strives for equity and provides a convenient vehicle for implementing policy. However, these policies necessarily increase tax code complexity. When the rules are complex, compliance and enforcement will be imperfect, undermining the effectiveness of the policies and imposing costs on taxpayers and the IRS. Tax code complexity enters into the taxpayer’s compliance decision in two ways. First, complicated regulations make it costly for the taxpayer to determine eligibility and to comply with documentation requirements. Second, complicated regulations are susceptible to multiple interpretations, increasing the likelihood that an IRS auditor’s interpretation as to eligibility will differ from the taxpayer’s. This uncertainty deters some eligible taxpayers while presenting an exploitable opportunity for others.

Contact With Revenue Authorities

IRS service initiated contact, either through auditing the taxpayer or sending out deficiency notices or other information inquiries, is a controversial compliance factor. One point of view that has found some support is that increased contact leads to increased resistance. Strumpel (1969, pp27-30) notes in a comparison of European tax structures that the history of taxation of southern European countries is rich in attempts to improve compliance by strengthening enforcement, yet these same countries have the very lowest compliance by strengthening enforcement, yet these same countries have the
very lowest compliance rates in Europe. Consistent with this observation, Spicer and Lundstedt (1976, p.303) in a survey of US taxpayers found that experience with tax audits was positively and significantly related both to increased tax resistance and to admitted tax evasion. Other studies have shown the opposite results and this has been supported by IRS research that showed that substantially more tax was reported by previously audited taxpayers than by others, but that this increase lessened by the second year, and disappeared by the third year [Westat 1980]

Aitken and Bonneville (1980, p. 54) questioned subjects regarding the difference an audit this year would make on their next year’s tax return. Almost 70% of the respondents said that it would make no difference in their care or honesty. Of those anticipating an effect, 21 percent thought an audit would cause them to be more careful the next year, but only 4 percent thought it would cause them to be more honest. Thus there is only a vague understanding of the impact of IRS contact.

**Probability of Detection**

Considerable attention has been focussed on the probability of detection (i.e. the likelihood that the IRS will discover a taxpayer’s non-compliance and will seek to rectify the deviance). One reason for the interest, of course, is that the Revenue can exercise some degree of control over this factor. The critical question is the extent to which raising the probability of detection will increase tax compliance. Studies of criminal behaviour in general have found that the probability of apprehension is more important than the sanctions actually imposed (e.g., Tittle and Logan(1973); Erikson and Gibbs (1976); and Lempert (1982). Focuses specifically on tax evasion, Mason and Calvin’s [1978, p.85] survey research shows that the independent variable with the strongest correlation with admitted evasion is the belief in the probability of not being apprehended.
Non-compliant taxpayers generally have been found to perceive a lower chance of detection than compliers as shown by Vogel (1974) and many others. Aitken and Bonneville's study indicates that respondents in general overestimate the chance of an audit. On average, the respondents estimated that 13 in 100 taxpayers at their income level are audited each year while, in fact, the average ratio of audits is closer to two in one hundred. Segmenting the general taxpayer population, Mason and Calvin (1978, pp. 85-87), suggest that women and elderly taxpayers believe that their chances of detection are higher, but that better educated taxpayers believe that their chances of getting caught are lower.

Since the probability of detection is subject to government control and manipulation, its influence has important tax policy implications. Consequently, the importance of research on this factor can be expected to increase as governmental authorities seek to combat non-compliance.

**Sanctions**

A key issue is whether legal sanctions are as important as interpersonal sanctions. Conflicting evidence has been found by researchers as to the relative importance of different types of sanctions and the interactions. Another important issue is the relationship between reported tax evasion and the severity of sanctions. Spicer and Lundstedt (1976) found no significant relationship between reported evasion and sanctions. Jackson and Jones (1985) found subjects more sensitive to the magnitude of the penalty than to the probability of detection when the probability is very low (i.e. 4% or less). Witte and Woodbury (1985) also observed a significant relationship between the severity of criminal sanctions and compliance by one group of taxpayers, high-income, self-employed individuals. This later study is consistent with Schwartz and Orlean's [1967] seminal work on sanctions.
Tax Rates

The compliance effect of marginal tax rates (i.e., the percentage of tax paid on the last dollar earned) has received widespread attention. There is empirical support for the assertion that high marginal rates decrease tax compliance. Despite some intuitive and empirical support, a few researchers have questioned the validity of the link between high marginal rates and tax compliance. Enrik (1963) and Lewis (1978) suggest that the majority of taxpayers are not aware of their marginal tax rate. If rate misperceptions are a norm, the intuitive appeal regarding this factor is considerably diminished.

Tax Return Preparers

In the US, since over 40 percent of all individual taxpayers use professional preparers (Department of Treasury, 1985), the influence of these preparers is another potentially important compliance variable. However, it is not known to what extent tax preparer and taxpayer penalties may impact the role of the preparer. Although a few preparers who dealt with the lower income taxpayers reported that they were viewed as government agents, Westat (1980), reported that most preparers believe they are viewed by their clients as client advocates.

Jackson and Milliron (1986) found that most research is concerned with intentional non-compliance, but there are many grey areas in the distinction between intentional and unintentional non-compliance. Furthermore, a major concern is whether taxpayers are technically able to determine their correct liability. The obvious problem of combining both types of non-compliance is that the motivations for each are much different and the characteristics of the offender are likely to vary. Similarly, the taxpayer who evades small amounts may be very different from one who evades larger amounts of tax. Conflicting conclusions in
the studies surveyed by Jackson and Milltron (1986) may be at least partially attributable to these variables.

Anderson et al. (2000)

Regulators and the professional tax practitioner community have vigorously debated the role of preparer penalties in curbing preparer aggressiveness. In 1989, this debate resulted in the American Congress’ adoption of the first “accuracy-related” preparer penalties: penalties based on the subjective strength or level of support for a reporting position rather than the culpability or diligence of the preparer recommending the position. Legislation was subsequently introduced in Congress calling for a doubling of these penalties. However, there is no empirical evidence supporting the effectiveness of such penalties in curbing aggressiveness, and prior experimental studies suggest their impact may be minimal.

This study clarifies and extends prior research in three ways: by isolating the economic incentives such penalties create from other, potentially conflicting, influences; by examining a wider range of services such penalties might impact; and by explicitly considering the moderating influences of market and institutional factors. They first developed a model suggesting that increased sanctions provide incentives for practitioners to not only reduce the aggressiveness of their reporting recommendations, but also to reduce the level of resources expended to identify relatively unambiguous tax-reducing opportunities and to increase the fees for their services. Any combination of these reactions might be expected in response to increased penalties and all should be considered simultaneously in an examination of the impact of penalties on practitioner behaviour. Further, they explicitly recognize that the ability to respond to increased penalties depends on the extent to which practitioners profit from the tax savings they generate, which in turn depends on the levels of competition and moral hazard in the environment.
They tested the model and its predictions in an experimental market setting in which the economic incentives related to penalties and penalty threats can be isolated from non-economic incentives. Subjects proxying as practitioners sold and delivered tax services in environments characterised by varying levels of penalties, competition, and moral hazard. They found that the practitioner-subjects significantly alter both the level and price of services they deliver in response to penalty increases. Further, these responses are mitigated by the levels of competition and moral hazard in the environment as predicted.

The results have implications for policymakers interested in using economic sanctions to regulate the delivery of professional services. The findings suggest that failure to observe effects of preparer penalties in prior studies examining professional subjects may be due to (1) subjects’ self-presentational concerns or other confounding non-economic influences, (2) failure to capture the full range of responses intended by subjects, and/or (3) subjects’ beliefs regarding potentially mitigating environmental and institutional characteristics. Further, the method used here to experimentally examine the tax practice environment can facilitate the development of a more comprehensive and predictive model of professional practice. They recommended that future research should seek to expand the present model by incorporating additional market, participant, and institutional characteristics, economic and non-economic, and considering their potential to moderate the effects of economic sanctions on practitioner behaviour.
Summary

This chapter examines the extensive studies carried out on tax compliance or non-compliance. As tax compliance research is at its infancy in Malaysia, the review is predominantly on studies done outside Malaysia, particularly in the United States of America. Several theoretical frameworks adopted by researchers in this field such as the Expected Utility Theory, Deterrence Theory, Prospect Theory and Exchange Theory have been examined. Emphasis is placed upon the Deterrence Theory that is closely related to this study involving increased penalties on tax advisers. Major studies related to the role of tax professionals have also been summarised. Researchers have also classified the variables and determinants of tax compliance according to economic factors, administrative and legal determinants and psychological attitudes. Smith and Kinsey’s (1985) classification into five categories and the American Internal Revenue Service classification of these variables have also been discussed. It must be noted that the above-mentioned studies do not reflect taxpayer behaviour conclusively and attempts to generate widely acceptable models of taxpayer behaviour have been unsuccessful. Worse still, the results are mixed and lacks consensus.

There are several reasons for this lack of resolution. First most researchers have adopted one of four methodological research approaches: (1) economic deterrence or analytic models, (2) regression modelling of aggregate tax agency data, (3) experimental research, and (4) survey research. Since each of these research mechanisms uses different techniques and sets of data, they sometimes lead to different conclusions. Second, the inconsistent findings are
not only the result of different tax systems and administrative procedures being practised between the countries in the survey but also because of different political values and basic ideologies of the public.

Most of the research work on the economic, sociological and psychological factors affecting taxpaying compliance and evasion that is being cited by researchers was done in the United States. As such the values and cultural nuances are unlikely to suit all tax jurisdictions. In addition the literature also suggests that taxpayer behaviour is complex and influenced by many non-economic factors (Alm et.al 1992).