

Centre for Tax System Integrity

Working Paper 76 – Tax compliance as the result of a psychological tax contract: The role of incentives and responsive regulation.

In this paper, the authors develop the notion of a psychological tax contract by looking more closely on the conditions that shape tax morale and confronting it with the empirical evidence found in the literature.

In *Section 2*, the theoretical basis of the psychological tax contract is provided by drawing on crowding theory (Frey, 1997). It particularly helps to emphasise the interactions between incentives and the intrinsic motivation to pay taxes. Positive (rewards) or negative incentives (deterrence) may reduce tax morale.

The evidence on the impact of deterrence on tax compliance is summarised in *Section 3*, while the hypothesised impact of rewards on tax compliance is discussed in *Section 4*.

Citizens may also perceive their tax payments as contributions to the ‘*bonum commune*’ such that they are willing to honestly declare income even if they do not receive a full public good equivalent to their tax payments as long as the political process is perceived to be fair and legitimate. The contractual relationship has additional implications for the procedural level: a friendly treatment of taxpayers by the tax office in auditing processes increases tax compliance.

In this paper, we have summarised evidence supporting such a view of responsive regulation. It moreover shows that the interaction between taxpayers and tax authorities is shaped by direct democratic decision-making. Responsive regulation is particularly successful and significantly more frequently employed in direct democratic cantons. Direct democracy, as such, leads to lower tax evasion and higher tax morale. In addition, deterrence occurs in a complicated fashion such that smaller offences are only punished lightly. Taxpayers are often given the benefit of a doubt. It is necessary to create a system that shapes the emergence of trust between citizens and between citizens and the state. This creates an environment in which it pays for citizens to follow their civic duty. This is likely to be relevant in all democracies.