

# The role of fairness in tax compliance

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The purpose of this paper is to study the relation between fairness considerations and tax compliance attitudes and intentions. Data from a large panel survey among small business owners in the Netherlands were analysed. Besides a number of background and control variables the questionnaire contained measures of personal norms, procedural and distributive justice, tax compliance attitudes and intentions to comply with tax rules. Results support the hypothesis that personal norms and justice concerns are related to tax compliance attitudes. Moreover, analyses confirm the hypothesis that distributive fairness positively affects both tax compliance attitudes and intentions to comply among entrepreneurs with relatively low personal norms, while distributive justice has no significant effect among entrepreneurs with high personal norms. Implications of these results for research on tax compliance and for tax policy are discussed. (*Netherlands Journal of Psychology*, 65, 136-145).

Keywords: tax; compliance; fairness; norms

It is generally acknowledged that the classical economic deterrence model for tax compliance (Allingham & Sandmo, 1972) fails to explain the high levels of tax compliance in societies. Although small effects of deterrence variables such as probability of detection and sanction severity are reported, the high levels of tax compliance do not arise from individuals who make rational choices based on purely economic self-interested motivations (Andreoni, Erard, & Feinstein, 1998).

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Received 11 August 2009; revision accepted 16 September 2009.

Therefore, other sources of motivations to understand tax compliance have been put forward, such as fairness considerations and personal norms or moral considerations of taxpayers.

Both fairness and personal norms provide important explanations about why most people comply with tax laws and why some are motivated to evade taxes. Generally, a positive effect of perceived fairness in tax-related affairs is found, meaning that perceived fairness will strengthen tax compliance. It is, however, not yet fully understood under which conditions and for which forms of fairness this positive effect occurs. Different conceptualisations of fairness seem to generate different results and previous studies sometimes failed to clearly specify which aspect or form of fairness was under scru-

tiny (see Kirchler (2007) for a recent overview of the empirical studies of fairness in relation to tax compliance).

A different type of explanation about why people obey laws concerns the norms that people use. A distinction is usually made between social and personal norms. In the field of tax compliance personal norms are defined as the belief that one is morally obliged to pay one's taxes, whereas social norms refer to the belief that relevant others will disapprove of tax evasion. Together these concepts are also referred to as tax morale (Frey, 2003; Torgler, 2002; Torgler & Murphy, 2004). In this study we will focus on personal norms. Empirical results show that personal norms make a strong predictor for tax compliance (e.g. Wenzel, 2004; Verboon & van Dijke, 2007). Although it is generally acknowledged that personal norms influence tax compliance, the exact relationship in combination with other concepts has received little attention and is as yet far from clear (Wenzel, 2005).

In the present paper we will therefore examine the relation between perceived fairness, personal norms and tax compliance. The present study focuses on small business entrepreneurs with less than 50 employees. The number of small businesses has grown substantially over the past decade in most Organisation for Economic Co-operation and Development (OECD) countries. In the Netherlands, 98% of all businesses now belong to this category. It is interesting to study the determinants of tax compliance in a sample of entrepreneurs, because the major objective of entrepreneurs is to make profits and paying tax may block this objective. Indeed, Ahmed and Braithwaite (2005) found that entrepreneurs expressed a relatively low tax morale and were more interested in tax avoidance than other people. Moreover, studies by Kirchler (Kirchler, 1998, Kirchler & Berger, 1998) have shown that considerations about the fairness of the tax system are important for entrepreneurs and that the various forms of fairness related to paying taxes are generally perceived as low by entrepreneurs.

### Fairness and tax compliance

Wenzel (2003) presents a conceptual framework for fairness in relation to taxpaying based on the social psychological justice literature, in which distributive justice, procedural and retributive justice are distinguished. Distributive justice refers to the fair distribution of outcomes in allocation processes. Equity theory (Adams, 1965; Walster, Walster, & Berscheid, 1978) states that exchange relationships are considered fair if costs and benefits are balanced. In the context of tax compliance, typical benefits are the share of public goods one receives and the most important costs are the actual taxes that have to be paid. The balance of these benefits and costs is re-

ferred to as exchange equity (Spicer & Lundstedt, 1976). Besides exchange equity other types of fairness, known as horizontal equity and vertical equity, are distinguished. Horizontal equity concerns the comparison of people's own cost-benefit ratio with that of others within the same social group, and vertical equity refers to the comparison with other social groups.

Perceptions of distributive fairness have been shown to affect tax compliance (for an overview see Wenzel, 2003 and Kirchler, 2007). People who experience their tax burden to be higher than others (horizontal or vertical inequity) tend to be less compliant with tax laws (e.g. Kinsey, Grasmick, & Smith, 1991). Likewise, exchange inequity also seems to undermine compliance (e.g. Moser, Evans III, & Kim, 1995). The more people are paid back in the form of public goods and services, the more compliant they will be, which is fully in line with equity theory predictions and social exchange theories.

Procedural fairness refers to the fairness of the allocation processes (Thibaut & Walker, 1975; Lind & Tyler, 1988). According to Leventhal (1980) procedures are considered fair if the following criteria are met: procedures should be consistent, accurate, free of errors, representative, ethical, and correctable. Tyler and Lind (1992) add other criteria to the procedural fairness concept, such as respectful treatment by authorities, voice and neutrality. Perceptions of procedural fairness are influenced by complexity of tax laws and non-transparency (Carnes & Cuccia, 1996), and by the efficiency of information desks, and a respectful and professional audit treatment (Wallschutzky, 1984).

Procedural fairness has been shown to be a highly influential concept for the cooperation of individuals within groups or with authorities (e.g. van den Bos, Wilke, & Lind, 1998; De Cremer & Tyler, 2005; De Cremer, Tyler, & den Ouden, 2005; De Cremer & Knippenberg, 2002; Tyler, 1990). Similarly, studies suggest that procedural fairness influences the acceptance of decisions made by the tax authority and builds trust in the tax authority among private tax payers (Braithwaite, 2003; Murphy, 2004). Procedural fairness is important for tax authorities, since by enacting fair procedures authorities support their legitimacy (Tyler, 1997; 2006). Although in tax research procedural justice has received less attention than distributive justice, there is some evidence that procedural justice is linked to tax (non-)compliance and tax morale. Kirchler, Niemiowski, and Wearing (2006) found that perceived supportiveness of advice by tax officers was associated with self-reported compliance and studies by Pommerehne and Frey (1992) and Torgler (2005) show that 'if taxpayers have a say in political decisions with regard to financial issues' tax morale is stronger.

Retributive justice refers to the perceptions of fairness of sanctions when rules are broken (Tyler, 1990). Perceptions of retributive unfair-

ness may occur when sanctions are too severe, or too mild. Although retributive fairness can be important for tax compliance, because it also relates to the legitimacy of the authorities, it is beyond the scope of the present study.

Entrepreneurs are concerned with profits and often experience fierce competition, which may lead to economic considerations in tax matters. This implies that for entrepreneurs not only economic deterrence will play an important role in decisions to comply, but also distributive justice concerns. Kirchler and Berger (1998) found that entrepreneurs tend to believe that taxes are distributive unfair, because their tax burden is experienced as higher compared with other people. Also exchange equity is relatively low among entrepreneurs since they associate taxes with bureaucracy and limitation of their freedom (Kirchler, 1998). Loss of freedom may lead to reactance (Brehm, 1966), which motivates to regain freedom, possibly by developing positive attitudes towards non-compliance. Kirchler (1999) indeed found evidence for the reactance effect among entrepreneurs. Moreover, entrepreneurs generally have more opportunities to evade taxes, for instance because they are more active in the cash economy. Many studies have shown that the opportunity to evade taxes is a highly relevant factor in non-compliance (see Kirchler, 2007 for references). We can expect that entrepreneurs who believe their tax burdens are higher than those of others, especially business competitors, will be more inclined to get even, if necessary by being non-compliant.

### Personal norms and fairness

As discussed above, previous findings suggest that people will be more prone to tax non-compliance when they experience low distributive fairness. Another determinant of tax compliance is the personal norm, described by Kirchler (2007) as a personality characteristic associated with honesty and moral reasoning. People with strong personal norms about tax paying will not seriously consider being non-compliant. Tax evasion is hardly an option for those people, even though they may find the tax system unfair. On the other hand, when norms about honestly paying ones taxes are weak we expect a relatively strong effect of fairness on compliance. Without a guiding tax moral one may seek to balance the perceived unfairness by cheating. Thus, we expect that strong personal norms will buffer the negative effect of unfairness perceptions on compliance. A similar argument is given by Wenzel (2004), who showed that personal norms moderated the effect of deterrence variables on self-reported non-compliance. Deterrence was only effective among people with low personal norms, whereas a much weaker effect was found among highly normative people.

In the present study personal norms are defined as a stable individual characteristic describing the internal norms about rule breaking in general. Law-abidingness and respect for authorities are closely related to this definition of personal norms.

This study utilises two different measures of non-compliance. The first is the general attitude towards non-compliant tax behaviour, where attitude is defined as a disposition to respond favourably or unfavourably to tax non-compliance. The second measure asks for the intention to be non-compliant. We expect the two measures to be related, since negative attitudes about tax paying will correspond to intentions to be non-compliant. However, unlike tax attitudes, intentions to cheat are expected to rely heavily on the possibilities to be non-compliant. Therefore the perceived possibilities to be non-compliant are of interest in this study. This leads to the following hypotheses.

- 1 Strong personal norms about rule breaking will lead to positive attitudes about tax compliance.
- 2 Perceptions of unfair distributions will lead to lower levels of tax compliance.
- 3 Perceptions of fair procedures by the tax office will have a positive effect on tax compliance.
- 4 High personal norms buffer the effect of distributive unfairness on non-compliance. The effect of perceptions of unfair distributions is particularly present among people with weak personal norms.
- 5 High personal norms buffer the effect of procedural fairness on compliance. The effect of procedural fairness is particularly present among people with weak personal norms.

### Method

#### *Sample*

The data for this study were taken from a cross-sectional survey among Dutch business entrepreneurs. The study was limited to businesses with less than 50 employees. The sample was drawn from three separate databases. With the exception of the agricultural and non-profit sector, firms were selected from the central database of the Chamber of Commerce. For agriculture and non-profit, samples were drawn from two other, more specialised, databases. A stratified sample was used in order to ascertain that all main sectors were equally represented. A total of 14,841 firms that matched the criteria for the study were initially selected. Of the 6036 owners who were contacted 2098 cooperated, for a response rate of 35%.

### Procedure

Initial contact with business owners was made by telephone. Respondents were asked to participate and could choose to answer questions by telephone or to receive a printed questionnaire. Most respondents opted for the telephone survey (92%). Trained interviewers conducted the telephone interviews. On average the interviews took 19 minutes.

### Respondents

Respondents were between 19 and 81 years of age ( $M = 46.2$ ) and 67% were male. Most respondents were the owner of the business (78%), the rest were seniors responsible for financial and fiscal affairs. On average firms employed three people, with 26% one-man businesses. The youngest firm was less than a year old, the oldest had existed for over 200 years ( $M = 21$  years). The average number of years respondents worked for the business was 12 years, ranging from less than a year to 57 years.

### Measures

The questionnaire contained questions on a number of background variables of both the entrepreneur and his or her firm. Furthermore, the survey contained multiple items on the attributes of interest.

*Possibilities for non-compliance.* The possibilities of transgressions of tax rules and of tax evasion was assessed with five items. We used multiple items concerning different legal obligations with regard to taxes, rather than the one item about opportunities for tax evasion in general that was used in previous studies (e.g. Wärneryd & Walerud, 1982; Webley, Cole, & Eidjar, 2001). Examples are: 'To what extent is it possible for a firm like yours to keep cash payments out of the records?' and 'To what extent is it possible for a firm like yours to employ people without paying the proper taxes?'. Response alternatives ranged from 1 (completely impossible) to 5 (very well possible). Cronbach's  $\alpha$  is .81.

*Deterrence.* Five items were used to assess the probability of being caught and seven items tapped the severity of the consequences of being caught. The five items on the probability of being caught were: 'What are the chances the Tax Office will find out that a firm has a) not kept its accounts according to the regulations; b) kept cash payments out of the records; c) entered too much or non-existent deductions in its tax return; d) not reported all income in its tax return; e) employed people without paying the proper taxes'. These items were similar to those used by Varma and Doob (1998) and Wenzel (2002). There were five response alternatives ranging from 1 (very low) to 5 (very high). The

seven items to assess sanction severity addressed different possible consequences of a detection of a transgression of a tax rule by the tax office (cf. Wenzel, 2002). Example items are: 'How serious would it be for your firm if a heavy fine were imposed?' and 'How serious would it be for you personally if a judge were to convict you for a tax rule transgression?' Response alternatives for all seven items ranged from 1 (very trivial) to 5 (very serious). Both the deterrence scales were found to be reliable, Cronbach's  $\alpha$  is .85 for the probability of detection and Cronbach's  $\alpha$  is .81 for sanction severity. Both scales were constructed in such a way that a higher score reflects a bigger probability of detection and an increase in sanction severity.

*Personal norms.* With four items respondents' personal norms with regard to transgressions of legal regulations were assessed (e.g. 'I feel morally compelled to follow all the rules'; 'Deviating from the rules a little does no harm'). Answers were scored on a five-point scale, ranging from 1 (disagree) to 5 (agree). The items were then combined to form a scale (Cronbach's  $\alpha = .60$ ). Because responses were skewed and we were particularly interested in distinguishing between people with low versus high personal norms, the scale was split to form a dichotomous variable distinguishing between people with low norms (about 25%) from those with high norms (see also Wenzel, 2002).

*Procedural fairness.* Procedural fairness was measured with seven items (Cronbach's  $\alpha = .76$ ). The items were based on Murphy (2004) and Tyler (1997) and were somewhat modified. Examples of items are 'The tax office treats everyone equally' and 'The tax office cares enough about the position of business entrepreneurs', with response alternatives ranging from 1 (disagree) to 5 (agree).

*Distributive fairness.* Distributive fairness was constructed from six items. The items were based on Kinsey and Grasmick (1993) and concerned exchange equity (e.g. 'From the taxes you have to pay, you get enough in return in the form of public services') and horizontal and vertical equity (e.g. 'In general, do you think you pay much or little on taxes?' and 'Do you think you pay much or little on taxes compared with other entrepreneurs?'). Answers were scored on five-point scales, with response alternatives ranging from either 1 (disagree) to 5 (agree) or 1 (very little) to 5 (very much). From the six items a scale for distributive fairness was created. Here a higher score reflects more distributive fairness; Cronbach's  $\alpha$  is .66.

*Tax compliance attitude.* The questionnaire contained four items to assess business entrepreneurs' tax attitude, conceptualised as their subjective evaluations of tax evasion (cf. Porcano,



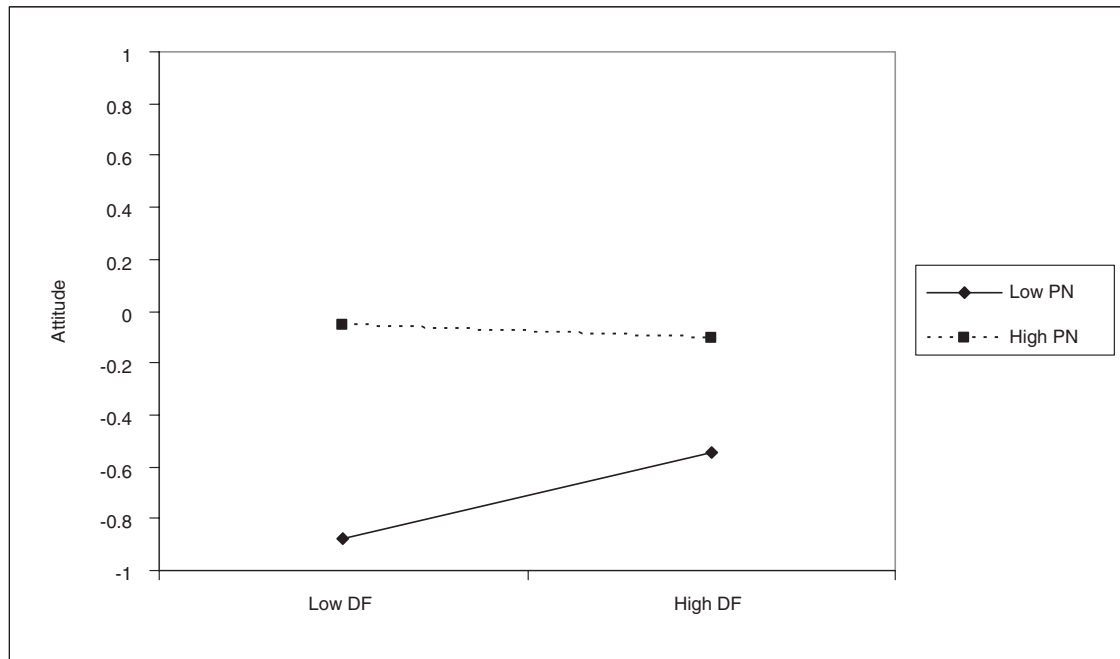
<b>Table 2</b> Results of regression analysis of fairness, personal norms and control variables on attitudes about tax compliance and intention to comply (n = 1268).				
Dependent variable	Attitude on compliance		Intention to comply	
	B	SE	B	SE
Constant	-0.20	0.07	-0.06	0.07
Number of employees	0.10***	0.02	0.05	0.02
Non-compliance possibilities	-0.10***	0.03	-0.37***	0.03
Probability of detection (PD)	0.05	0.03	0.06*	0.03
Sanction severity (SS)	0.08**	0.03	0.07*	0.03
SS x PD	0.01	0.03	0.03	0.03
Personal norms	0.16***	0.03	0.01	0.03
Procedural fairness	0.09**	0.03	0.01	0.03
Distributive fairness	0.01	0.03	0.06	0.03
Norms x distributive fairness	-0.08**	0.03	-0.08**	0.03
Norms x procedural fairness	0.02	0.03	0.00	0.03
	R <sup>2</sup> = 0.091 R <sup>2</sup> <sub>adj</sub> = 0.083		R <sup>2</sup> = 0.174 R <sup>2</sup> <sub>adj</sub> = 0.168	

\* p < .05, \*\* p < .01, \*\*\* p < .001.

The regression model explained 9% of the variance in tax compliance attitudes. The regression weights of the number of employees, possibilities for non-compliance and sanction severity were significant. Larger firms, in terms of numbers of employees, had more positive attitudes towards tax compliance than smaller firms. When more possibilities for non-compliance were reported, tax compliance attitudes were less positive. Tax compliance attitudes were also more positive when perceived sanction severity increased. As expected, both personal norms and procedural fairness had a positive association with tax compliance attitudes. Contrary to expectations, the association between distributive fairness and tax compliance attitudes did not reach significance. However, the interaction between personal norms and distributive fairness was significantly related to tax compliance attitudes. In order to clarify the interaction a simple slope analysis (Aiken & West, 1991) was conducted (Figure 1). There was a significant positive association between distributive fairness and tax compliance attitudes among small business entrepreneurs with relatively low personal norms ( $B = 0.16, p < .05$ ), and no association between distributive fairness and tax compliance

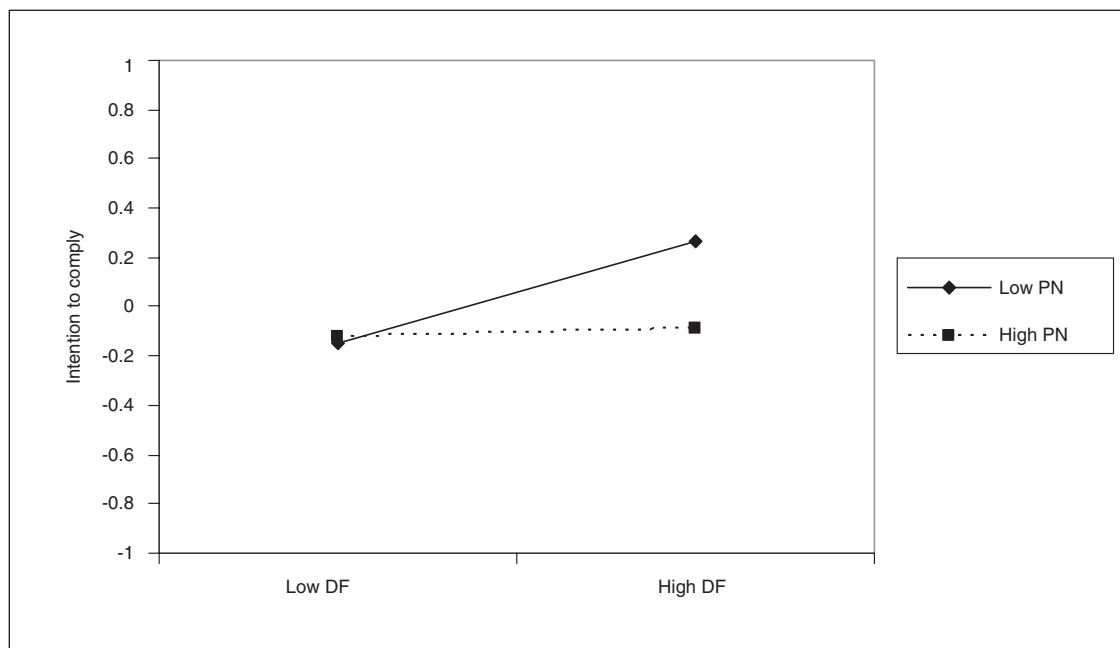
attitudes among entrepreneurs with relatively high personal norms ( $B = -0.03, ns$ ). This result confirms our prediction that distributive fairness is especially important for entrepreneurs with low personal norms. The interaction between procedural fairness and personal norms was not associated with tax compliance attitudes.

In total 17% of the differences in intentions to comply were accounted for by the regression model. Here, possibilities for non-compliance, probability of detection and sanction severity had significant beta weights. The intention to comply was stronger when entrepreneurs perceived less possibilities for non-compliance. When the perceived probability of detection was higher, and also when perceived sanction severity was higher, intentions to comply were stronger. The interaction between these deterrence variables was not significant. Distributive fairness was marginally associated ( $B = 0.05, p = .08$ ) with the intentions to comply. None of the other main effects reached significance. Again, the interaction between distributive fairness and personal norms was significantly associated with compliance intentions. Simple slope analysis revealed the association was similar to the asso-



*Figure 1*

Simple slopes illustrating interaction effect of distributive fairness (DF) and personal norms (PN) on compliance attitudes.



*Figure 2*

Simple slopes illustrating interaction effect of distributive fairness (DF) and personal norms (PN) on intention to comply.

ciation on tax compliance attitudes (Figure 2). A significant positive association between distributive fairness and intentions to comply was found among small business entrepreneurs with relatively low personal norms ( $B = 0.21, p < .01$ ), while there was no significant association between distributive fairness and intentions to comply among entrepreneurs with relatively high personal norms ( $B = 0.02, ns$ ).

## Discussion

This paper set out to examine the role of personal norms and fairness considerations for tax compliance attitudes and intentions of small business entrepreneurs. The results of this study support the idea that procedural fairness as well as distributive fairness influence the way entrepreneurs feel about tax compliance.

Before discussing the results further, some limitations of the study should be addressed. Because cross-sectional data were used, claims about causality of the associations between variables are impossible. Also results are taken from one study, which may limit the robustness of the results. However, the hypotheses were based on sound theoretical work as described in the scientific literature, which makes the proposed causal explanations plausible. Furthermore, most results are in line with previous research, which gives confidence that the results are indeed robust. Hessing, Elffers, and Weigel (1988) noted that a distinction must be made in tax compliance research between measures based on self-reported non-compliance and observational data. The first set of measures is related to subjective norms and attitudes, whilst the second is more related to dissatisfaction with authorities, competitive orientations and egoism. Moreover, self-reports on non-compliance do not always correspond with actual non-compliance behaviour (Elffers, 1991). An important restriction of actual non-compliance behaviour is the perceived opportunity to evade. Without opportunities to evade, negative tax compliance attitudes will not lead to actual tax evasion. Clearly, this study belongs to the set of studies that has used self-reported measures of non-compliance. Generalising the results that were found in this study to actual tax cheating should therefore be done with great caution.

Research among private tax payers generally showed a direct link between distributive fairness and both tax compliance attitudes and intentions to comply with tax rules (e.g. Kinsey, et al., 1991; Moser, et al., 1995). In contrast, the present results showed that distributive fairness had no direct effect on tax compliance attitudes and only marginally on intentions to comply. One possible explanation for this result may be the fact that our sample consists of small business entrepreneurs, whereas previous studies predominantly focussed on private tax payers. This would imply that distributive fairness considerations operate differently for private tax payers as compared with small business entrepreneurs. The scarce studies that compared entrepreneurs with private tax payers indeed suggest that the two groups differ with regard to tax-related issues (Ahmed & Braithwaite, 2005). The results further showed that the relationship between distributive fairness and tax compliance was qualified by personal norms. The analyses revealed a significant interaction effect between personal norms and distributive fairness on both tax compliance attitudes and intentions to comply with tax rules. For entrepreneurs with high personal norms on rule transgressions in general, distributive fairness neither affects tax compliance attitudes nor intentions to comply. Only entrepreneurs with low personal norms

with regard to rule transgressions are sensitive to distributive fairness. When personal norms are low, tax compliance attitudes are more negative and intentions to comply are weaker when entrepreneurs consider their tax burden as unfair.

The present study also showed a direct effect of procedural fairness on tax compliance attitudes. Consistent with the existing literature (e.g. Murphy, 2004), analyses revealed that when more procedural fairness was perceived, more positive attitudes towards tax compliance emerged. However, procedural fairness did not affect intentions to comply with tax rules. This latter result differs from previous studies (e.g. Kirchler, et al., 2006), but is in line with results reported by Porcano (1988), who found no effect of procedural fairness on non-compliance intentions. Because both conceptualisations of non-compliance and samples differ among studies, it is difficult to assess what the causes are for these mixed results.

Contrary to expectations, personal norms did not moderate the effect of procedural justice on tax compliance attitudes and intentions to comply. Procedural fairness thus seems to shape tax compliance attitudes of business entrepreneurs, irrespective of personal norms, but does not directly or indirectly affect intentions to comply. The fact that distributive fairness and procedural fairness have idiosyncratic effects on tax compliance stresses the importance of clearly distinguishing between the types of fairness that are under investigation (cf. Wenzel, 2003).

The present study came up with evidence that personal norms not only directly influence tax compliance attitudes, but that personal norms also moderate the effect of distributive fairness on these attitudes and on intentions to comply. This outcome is further support for Wenzel's claim that high personal ethics 'exclude tax evasion from one's behavioural options' (Wenzel, 2004). In Wenzel's study the effect of deterrence variables on self-reported non-compliance was delimited by personal norms, whereas in the present study it was shown that the effect of distributive fairness on non-compliance attitudes and intentions was delimited in a similar way by personal norms.

The results thus imply that in order to promote tax compliance among small business entrepreneurs, authorities could take action to ensure that entrepreneurs perceive the tax system as fair. Potential tax evaders are those people with low personal norms, and especially for these people distributive fairness seems to influence tax compliance attitudes and intentions. Thus, by increasing distributive fairness perceptions, especially among people with low personal norms, tax compliance attitudes might improve and intentions to be non-compliant could decrease.



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