Tax Compliance in the Perspective of Behavioral Economics

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Abstract. Tax is the main source of state revenue which is influenced by the level of public compliance in paying taxes. The more obedient the people, the greater the potential for tax revenue. This conceptual paper discusses psychological factors that influence the level of compliance in paying taxes. The purpose of this paper is to use a behavioral economics approach to understand taxpayer behavior by discussing confirmation bias, herding and framing.

Keywords: tax compliance · confirmation bias · herding · framing

1 Introduction

Tax is one of the main sources of funds used by the government for development. With a large population, the potential for tax revenue is also getting bigger. Nevertheless, the potential for large tax revenues must also be balanced with compliance from taxpayers. Tax compliance is the level of public willingness to fulfill tax obligations in accordance with applicable regulations.

According to Trivedi et al., (2003), the most influential factor on tax revenue is the level of tax compliance. In line with Trivedi and Lynn, Chau & Leung (2009) also stated that the level of public taxpayer compliance in a country will affect tax revenue. The more obedient (non-compliant) taxpayers, the greater (smaller) the potential tax revenue to be received.

So what affects the level of tax compliance? Witte & Woodbury (1985) found that tax audits and sanctions or fines set by the tax authorities were the main motivators of taxpayer compliance. Helhel & Ahmed (2014) who conducted research in Yemen concluded that low taxes and a fair tax system were the main causes of tax compliance. Both of these opinions see the factor of tax compliance coming from the external side of the taxpayer.

A different view was expressed by Alm & Torgler (2006) who saw this compliance factor as coming from the internal side of the taxpayer. According to them, motivation from within a person (intrinsic) to pay taxes (tax morale) and religious observance are the determinants of tax compliance. Tax morale itself is related to trust. The results of his research show that a tax system that is considered transparent makes taxpayers in America the most compliant taxpayers to pay taxes compared to 14 other European countries. Religious organizations also play a positive role in shaping immorality. Those

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who are devout in worship tend to have a higher level of tax compliance. This opinion illustrates that understanding individual behavior is one way that can be done to increase the level of tax compliance.

2 Behavioral Finance

In traditional economic theory, individual behavior is based on the assumption that humans are rational beings. Humans are creatures that are considered capable of making unbiased decisions and will try to maximize utility. In terms of taxes, it is assumed that taxpayers will only consider profit and loss factors. This perspective will see that taxpayers will comply with taxes if it can provide benefits for them, and vice versa.

The domain of rationalists is getting wider along with the increasing use of economics of mathematics as a capital that makes it easier to understand. This rationality was even able to influence macroeconomic policies, especially in America and England in the 1970s (Hidajat et al., 2020).

In contrast to other rationalist economists, Robert Shiller in the early 1990s proposed his ideas on behavioral economics or behavioral finance which refuted the assumption of rationality. Together with Richard H. Thaler, Shiller developed behavioral finance as a new concept that combines behavioral and psychological aspects of economics and financial decision making that help understand why investors behave in a certain way.

Belsky & Gilovich (2010) defines behavioral economics as a combination of psychology and economics to explain why and how people make irrational or illogical decisions when spending, investing, saving and borrowing money. In other words, behavioral finance is a combination of psychology and economics that explains why and how people make irrational or illogical decisions. The question that then arises is: is behavioral economics relevant to understanding taxpayer behavior?

3 Behavioral Finance and Tax Compliance

Until now there are many studies that use the behavioral economics approach to understand taxpayer behavior. For example, Weber et al. (2014) stated that behavioral economics is the right approach to understanding tax compliance behavior. In this approach, tax compliance cannot only be seen from rational considerations, namely profit and loss alone. There are other factors that influence why taxpayers become tax compliant or noncompliant, namely psychological factors that manifest in behavioral biases.

Behavioral bias according to Pompian (2006) consists of two groups, namely emotional bias and cognitive bias. Cognitive bias or cognitive bias is decision making using a rule of thumb for information or facts, while emotional bias is decision making based on feelings or emotions.

In terms of tax compliance, behavioral biases can manifest as an example through Cognitive Bias, namely Confirmation Bias, herding and framing. Confirmation bias is a person's tendency to seek information that supports his opinion or overrides information that does not support his opinion. Confirmation bias is a cognitive bias that has an impact not only on how people collect information, but also affects how to interpret and remember information so that it is in accordance with their opinions or beliefs (Hidajat, 2019). For example, taxpayers who do not comply with taxes will prefer an analysis that concludes that taxes are not beneficial for development, the tax system is not transparent, and so on.

Herding is the tendency of someone who prefers to follow others or imitate group behavior in making decisions rather than deciding alone. Someone who is basically tax compliant will behave in the opposite way because he imitates a group or community environment where most of its members are not tax compliant.

Representativeness bias is quick decision making by assuming the existence of certain influential figures/individuals is a representation of something that is believed. According to Yong (2013), a person carries out this bias when he makes judgments based on certain stereotypes. The existence of community or religious leaders who avoid taxes will become a 'representative' of taxpayer non-compliance.

The level of compliance with taxes will get stronger when framing bias occurs. This bias has a significant role because it can affect the decisions taken from the information presented. Framing according to MM Pompian (2006) is " the tendency of decision makers to respond to various situations differently based on the context in which a choice is presented (framed)". Framing is a tendency to respond or make decisions based on the context of the information presented (framed).

Twersky & Kahneman's (1981) classic work on framing shows that decision-making can be influenced by how choices are presented. Sniderman & Theriault (2004) stated that "it is widely agreed that citizens in large numbers can be easily blown from one side of an issue to the very opposite depending on how the issue is specifically framed".

This shows that sources of information such as the mass media have a great influence on people's way of thinking. Information presented both positively and negatively will thus be able to influence one's decision making. Coverage in the mass media that says "75 percent of taxpayers pay taxes on time" can influence a person to become tax compliant. Conversely, the mass media that reports "25 percent of taxpayers are late paying taxes" can influence someone to not comply with taxes.

These three biases are temporary conjectures that still have to be proven true. Further research is needed to find out what biases need to be made so that people become tax compliant.

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