

Alan Lewis

**THE PSYCHOLOGY
OF TAXATION**

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The Psychology of Taxation

ALAN LEWIS

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The Psychology of Taxation

To my mother and father

Preface

This book is about the cross-fertilization between the disciplines of economics and psychology and, in particular, between aspects of public economics and social psychology.

The romance between psychology and economics has had its ups and downs and goes back at least as far as Gabriel Tarde's book *La psychologie économique* (1902) and the emergence of economics as one of the moral sciences (cf. Boulding, 1969). This romance appeared to be on shaky ground during the econometric revolution, when few attempts were made to assimilate psychological concepts; rather, economists set about purging their theories of all psychological content. However, interest was considerably revived through the work of George Katona, in his book *Psychological Analysis of Economic Behaviour* (first published in 1951). Furthermore, 1981 heralded the first edition of the *Journal of Economic Psychology* and the gathering together of some determined research work from Europe and the USA. Yet it is true to say that the romance has remained flirtatious and is still to be fully consummated. The present volume is an attempt to bring this consummation a little closer.

The central theme of this book is that the attitudes, perceptions and preferences of taxpayers can be studied and that this contributes to our understanding of fiscal mechanisms. In particular, the influence of attitudes towards tax and public expenditure preferences (taken together as fiscal preferences) are studied in relation both to the implementation of fiscal policy and to economic behaviour, including the incidence of tax evasion.

Many present-day economists would agree that attitudes have an important influence both on the effects of tax policies and on fiscal policies through various political processes. Stated differently, there are intervening variables between economic stimulus and economic response. However, according to the tenets of logical positivism (a philosophy with the upper hand in economics as well as in some

branches of psychology – for example, behaviourism), attitudes must be shown to be open to scientific observation (and, furthermore, to improve economic predictions) in order to be worthy of pursuit. An argument for the predictive value of attitudes is made with respect to tax-evasion behaviour, as well as other explanatory demographic and psychological variables, in interpreting tax attitudes and fiscal preferences beyond those incorporated in narrow self-interest hypotheses. However, it is also argued that attitudes contribute to our understanding of economic phenomena and that comprehension is as important as, if not more important than, pure prediction. Comprehension and prediction may not always be on opposite sides of the same coin.

The ideas expressed in this book do not constitute a major criticism of economic theory; neither do they offer a new economic treatise. The concept of rationality, expressed as the belief that people attempt to get what they want, whatever that may be, should cause few problems between the disciplines, as most psychologists view behaviour as largely purposive. Neither need there be any fundamental disagreements between the two disciplines about a more broadly based view of self-interest, incorporating optimizing and satisficing behaviour and the utilities of others. The biggest differences arise from the fact that economics is largely a deductive science and psychology an inductive one. While economists make assumptions about rational economic man, and predictions based on those assumptions that can be tested by empirical observations, psychologists tend to derive their model of man from the observations that they make.

Part I begins with an outline of the many overlaps between psychology and economics, a review of the aims of the book and discussion of the relevance of psychology in answering tax-research questions. The importance of attitudes is stressed; the study of attitudes remains one of the major concerns of social psychology. In the appendix brief mention is made of some of the most frequently used attitude measures, but readers interested in assessing attitudes for themselves and in conducting attitude surveys are directed elsewhere (e.g., Oppenheim, 1966; Moser and Kalton, 1971). The last section of Part I is concerned with the notion of rational economic man, which is a recurrent theme. This thorny and complicated subject requires elucidation, as the concept is easily misunderstood.

Part II presents details of tax attitudes, perceptions and preferences derived from social surveys conducted in Europe and the USA. A

discussion of the possible nature of tax attitudes and their structure follows. Policy orientation is emphasized in a consideration of the political and psychological aspects of referenda and of their role in political economy and in the relationship between public opinion and fiscal policy making. This account is not confined to a review of the literature. For instance, a critical view is taken of the way in which tax attitudes and preferences have been assessed and of the question of whether their assessment can be 'value-free' in the sense used in positive economics. The study of attitudes is not presented as a panacea for solving research problems in public economics and political economics.

Part III is concerned with the vexing problem of tax evasion, which appears to be growing in many Western capitalist countries. A call is again made for the consideration of tax attitudes in understanding tax-evasion behaviour, and evidence is presented from social surveys on taxpayers' attitudes towards tax evasion. The possible predictive value of attitudes is outlined, and some methods for reducing tax evasion, derived from economic, psychological and sociological theories and findings, are compared and contrasted.

Part IV is largely speculative. It considers some new excursions into the interdisciplinary study of the comprehensibility of tax literature and communications between taxpayers and tax authorities and different approaches to the effects of taxation on labour supply.

Part V, the final section, presents a brief summary of the positive or normative role of psychology in fiscal policy-making, and the future of fiscal psychology.

Fiscal policies are the major tools that a government wields in controlling the economy. Consequently, a book on the psychology of taxation must incorporate notions not only of psychology and economics but also of sociology, political economy, political science and fiscal, public and social policy. This is truly an interdisciplinary book and therefore must be considered an ambitious one. In this age of academic specialization, no author could be expected to be fully conversant with all of these fields; the present author is no exception. The hope is that there are no glaring errors and that some sections are of interest to people from all of these disciplines. A further consequence of an interdisciplinary book is that, inevitably, particular sections will seem simplistic to some and difficult to others. An effort has been made to make each section comprehensible to people from all the disciplines mentioned, if they persevere.

This book may require pure economists to accept a widening of what they have hitherto considered to be the boundaries of their discipline, though political economists may not find the extension too troublesome to assimilate. As for psychologists, the book applies psychological theories and findings in an area that they have largely neglected in the past and underlines the importance of economic behaviour as the subject of psychological study.

If this book goes some way towards encouraging students and researchers in economics, political economics and public and fiscal policy on the one hand and psychology on the other to become more interested in each other's work, then the effort of writing it will have been worthwhile.

Alan Lewis
1982

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PART I

Introduction: Psychology and Taxation

Background

After the Second World War, economic psychology began to revive. This revival was largely a consequence of George Katona's book *Psychological Analysis of Economic Behaviour*, first published in 1951. Much of his work can be incorporated within the boundaries of social psychology, and this is the direction in which the present volume leans. However, as Simon and Stedry (1969) have pointed out, many of the links between the two disciplines were originally between micro-economics and experimental psychology, arising from a mutual interest in choice and decision-making behaviour. Experimental psychologists have contributed to the literature on real-life choices and have considerable sympathy with models of choice, which include uncertainty (e.g. Arrow, 1951) and expectations (Arrow, 1958, 1963; Ozga, 1965). In particular, experimental psychologists have become interested in 'subjective probabilities' (Edwards, 1953) and in the differences that can be observed between subjects' own estimates of the outcomes of their choices and those imputed by an observer or researcher. The 'rationality' of the decision-making process has also been investigated, leading to a distinction between 'substantive' and 'procedural' rationality (Simon, 1976). Substantive rationality relates to the understanding of the term as it is used in economic theory, referring to purposive behaviour appropriate to the achievement of given goals within the limits imposed by various conditions and constraints. Procedural rationality is the term, mainly used by psychologists, that concentrates, on assessing the degree of deliberation and the cognitive processes and limitations of individuals when making decisions.

George Katona's concept of 'expectations' provides the major historical and empirical link between social psychology and economics. Here expectations are viewed in terms not only of the degree of uncertainty about the anticipation of the outcomes of personal choices but also of the ways in which expectations develop through

past experience and people's anticipation of future price changes and wage levels, for example, affect their expenditure patterns. This dynamic view of economic behaviour stresses that the psychological states of minds of consumers can have macro-economic consequences and that these psychological variables can improve econometric forecasting.

Katona's research mainly employs social-survey techniques in his measures of consumer sentiment, the responses from which were intended to challenge the mechanistic assumptions of economists and, furthermore, to improve predictions, especially those relating to spending patterns. One of the mainstays of the index of consumer sentiment is this concept of 'expectations', derived from Katona's interest in *Gestalt* psychology. The concept incorporates an individual's interpretation and experience of past events in his anticipation of the future. In the context of saving patterns, expectations relate to personal finances, business trends and buying conditions. Much to Katona's delight, he was able to show that these variables, frequently overlooked by economists and econometricians, showed that downturns in consumer sentiment preceded the recessions in the USA in 1969 and 1973, at a time of otherwise relatively stable economic activity (Katona and Strumpel, 1978). While Katona is understandably cautious about the role of consumer expectations and attitudes in the economy, his case is well made that public attitudes should be included in econometric forecasting and that micro-economic analysis of this kind is useful in predicting macro-economic consequences.

Katona has extended his thesis of the value of micro-economic survey data to include aspects of inflation, business motivation and business cycles. All of these sections in his book seek to illustrate the advantages of including psychological considerations. In view of the comprehensiveness of Katona's writing, it may come as no surprise to learn that he had something to say about taxation and fiscal matters too, although it was his sometime associates, Eva Mueller and Burkhard Strumpel, who have published most widely on these topics. Katona has pointed out that changes in fiscal policy – cuts in income tax for example – frequently fail to have the desired effect on, say, work motivation and job creation. This is because the public may persist with previous economic behaviour as though it were ignorant of these fiscal changes. Katona depicts the man and woman in the street as creatures of habit; while tax cuts are frequently used to try to

stimulate and reflate the economy, people may be guided less by this policy measure than by their own economic forecasts, expectations and perceptions. The issue may be not whether the sentiments of the public matter in this regard, but how much they matter. As Tobin (1972) has argued, economic attitudes may themselves be strongly governed by objective economic realities. Hence unpredicted reactions to fiscal policy initiatives may simply be understood (using the terminology of economic forecasting) in terms of 'lags'; in time economic behaviour will follow economy theory, once people catch up with what really is going on. Therefore psychological factors may be extremely valuable in interpreting short-term reactions but may act like so much icing on the cake in the longer term. Even if this view is accepted, the value of psychology is not undermined, for we live in a period of volatile public sentiment and rapidly changing economic circumstances.

However, Katona would not be satisfied with mere icing and has shown, using data from surveys conducted in the periods 1963–5 and 1967–8, that tax changes do not result in symmetrical changes in effective demand (Katona, 1975). Rather, non-economic considerations, such as trust and confidence in government among taxpayers, were more important influences on the economic behaviour of individuals than were the fiscal changes themselves. As further evidence of the potency of Katona's arguments, he quotes a section of page three of the Economic Report of the President to Congress, 2 February 1970: 'We have learned that there is a human element in economic affairs – habit, confidence, fear – and the economy cannot be managed mechanistically' (Katona, 1975:1b). Whether or not these comments benefited from Katona's research is unclear; the juxtaposition of research and report is persuasive enough.

Eva Mueller (1963) and Burkhard Strumpel (1969) have conducted research into attitudes to tax and public expenditure rather than attempting to assess the effects of fiscal policy changes on economic behaviour generally. Strumpel (1969) has been particularly interested in the description of tax perceptions and attitudes as intervening variables between the independent variables of the tax system (e.g. marginal tax rates) and the dependent variables of tax compliance. Strumpel (1968, 1969), Beicheit *et al.* (1969), Schmolders (1959) and others have termed these attitudes and perceptions 'tax mentality' and Enrick (1963, 1964) the 'tax consciousness' of taxpayers. The model predicts that tax evasion is a consequence not only of the tax