

Tax Compliance and Loss Aversion (Engström et al., 2015)

Prospect theory is a theoretical model to predict human behavior when facing uncertainty. It captures how a loss hurts more than the satisfaction of a win. It follows that humans will try to avoid losses as much as they can.

One Sentence Summary

When people get a deficit (active tax payment) in their preliminary income taxes, the probability of filing a deduction (pay less taxes) increases. A consistent surplus on preliminary income taxes can increase tax compliance.

Main Findings

In Sweden the income tax system is straightforward. The company will withhold a percentage of an employee salary each month. Near the end of the year, each person will get a preliminary tax report. In the preliminary report it will show the difference of actual tax payment and the accumulative withheld salary. This difference will be called a deficit if the actual tax payment is higher than the withheld salary. At the end of the fiscal year, the person would need to pay if the preliminary report showed a deficit.

Imagine two people A and B. Both need to pay 30 dollars in taxes. On their preliminary reports A had a deficit of 1 dollar, while B had a surplus of 1 dollar. Classic economic theory will predict that A and B will have the same probability to file for deduction. Because it will decrease the tax payment and both face the same taxes, but with a difference in withheld salaries.

Using prospect theory there should be a difference in probability. Because actively paying the tax hurts way more than the satisfaction of gaining that extra dollar. Therefore, A will do anything in their power to reduce this pain, even if it means lying. When the preliminary taxes report a deficit, people will be more inclined to file deduction for "other expenses for earning employment income". Meanwhile agent B does not perceive the same pain and will not have an extra incentive to file for deduction. In 2006 the authors report that 93% of audited cases of deduction were rejected, meaning that A will lie to reduce the pain of paying.

Concluding Remarks

Using this insight, making all the preliminary taxes to report a surplus can increase tax compliance (tax payment) and avoid unnecessary deduction audits. Moreover, this adds to the empirical evidence of prospect theory, which can be a better explanation for human behavior than the expected utility theory.

References

- Engström, P., Nordblom, K., Ohlsson, H., Persson, A., 2015. Tax Compliance and Loss Aversion. Am. Econ. J. Econ. Policy. <https://doi.org/10.1257/pol.20130134>.