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Role of Ethics in Tax Compliance

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ABSTRACT

Existing literature suggests that there has been an increase in the ratio of trade to GDP over the years and this is a direct indicator of the growing integration of the Indian economy with the global economy. Also, an important characteristic of the FDI coming into India is that a whopping 53% of it comes from low tax countries which proves the existence of aggressive tax planning and Base Erosion and Profit Shifting (BEPS). Considering the rising interaction of the domestic economy with the global market, issues pertaining to taxation come into play. It is observed that multinational corporations often shift profits to low tax jurisdictions and tax havens to reduce their tax liability. Individual citizens also engage in tax evasion and avoidance. In such scenario, emerging conversations on ways to reduce tax evasion and avoidance is important. Traditional sanctions are a common way to achieve that but the present paper explores the role of ethics and moral appeals in ensuring tax compliance and also notes the importance of tax literacy. It is concluded that moral appeals must be incorporated in the traditional sanctions system for greater long-term benefits.

Keywords: Tax Avoidance, Tax Compliance, Tax Evasion, Morality, Tax Literacy.

I. INTRODUCTION

Every country needs funds to provide its citizens with essential services. Taxes are a major source of revenue for the government. Government imposes various types of taxes: direct and indirect being the two major ones. Direct taxes are those which are directly payable from the citizen to the government, these are most commonly imposed on income. Whereas, an indirect tax is a tax levied on goods and services.

Budget reports indicate that during 2012-2016 tax revenue constituted at least 85% of the government's total revenue.² Hence, it can be said that the nation has a significant dependence on taxes to run its various operations. In order to ensure that all citizens dutifully pay their taxes, an efficient system must be in place and this is called the tax administration system. A set of rules and regulations need to be strictly adhered to, to ensure that there are no

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² [India Budget](http://www.indiabudget.nic.in), www.indiabudget.nic.in (2016).

unscrupulous practices. Unethical behaviour even at the most basic level can be detrimental since it can lead to corruption, bribery, money laundering and other more severe financial crimes.

These wrongful practices have long lasting negative effects on the growth and development of an economy. India, being a rapidly developing economy, has very strict laws governing tax compliance. However, still unfair practices are prevalent. Citizens engage in tax evasion and tax avoidance frequently. Where tax evasion involves engaging in illegal activities to reduce one's tax burden, tax avoidance is just finding loopholes in the current tax administration system to avoid paying all the taxes that one is legally required to.

Tax evasion not only has a direct impact on the country's economy but it also affects the international economy as a whole. According to an OECD report combating international tax evasion is essential since it is a major source of illicit financial flows from several developing countries.³ The report suggests that transparency is very important to ensure that citizens comply with all the tax laws. However, mostly developing countries face a problem in this respect because their tax systems are not strong enough and are more prone to corruption, which makes them more susceptible to tax evasion.

There is no clear estimate of black money in India however, according to a report submitted by the National Institute of Public Finance and Policy (NIPFP) in December 2013⁴, the black money economy could be three-fourths the size of the Indian economy; which is concerning. However, after demonetisation in 2016, a lot of black money came into legal circulation and there was an increase in the number of people filing income taxes. Still, considering the problem and the size of the country, we still have a long way to go.

All the above-mentioned problems boil down to the taxpayers. What motivates or influences some citizens to pay taxes and what causes others to evade them? Tax compliance is a multi-layered issue which is affected by several factors. Hence, this paper seeks to evaluate the role of morality and ethics in tax compliance.

(A) Objectives

With this paper, the researcher aims to achieve the following objectives:

1. To understand the impact of tax evasion on the economy of a country
2. To explore the reasons as to why people engage in tax evasion

³ Kjetil Hansen et al., OECD, Illicit Financial Flows from Developing Countries: Measuring OECD Responses, (2014).

⁴ National Institute of Public Finance & Policy Annual Report 2013, (2013).

3. To understand the role of ethics in tax compliance

(B) Research Questions

The purpose of this paper is to answer the following research questions:

1. Is the traditional system of imposing sanctions effective in reducing tax evasion?
2. What is the role of moral appeals in ensuring tax compliance from citizens?

(C) Review of Literature

Tax evasion has a significant negative impact on the growth of an economy. Thus, to ensure tax compliance the government undertakes two kinds of measures. These can be classified as positive and negative incentives. Positive incentives include giving special benefits to a certain group of taxpayers, such as tax holidays, Special Economic Zones (SEZs), etc. Whereas, negative incentives involve imposition of strict penalties in the event of non-compliance. Over the years, some research has been conducted to explore the relation between ethics and tax compliance.

Bahari & Ling (2009)⁵: The researchers sought to understand the importance of tax education. They found that a whopping 64% of non-business respondents wished to learn and gain awareness about basic tax principles. They suggested that a tax education program should be inserted for students from a non-accounting background in higher education.

Amoah et al. (2014)⁶: The paper analysed the problem of tax evasion in Ghana. It analysed various arguments which seek to justify tax evasion and found that if the citizens believe that the tax administration system is inherently corrupt then they are less likely to comply with tax laws and other regulations. These arguments were also affected by the difference in respondents' demographic profile (gender, employment status, age, religion).

Hastuti (2014)⁷: The paper stated the importance of tax education amongst young college graduates, since they are the next generation of work force who will eventually pay taxes. It emphasises the need for tax education to ensure tax compliance. The research aimed to understand the ethical and contextual differences between business and non-business students regarding their tax awareness. The study indicated that there were no significant differences between the two groups. Both groups were of the opinion that tax education is essential and

⁵ AB Mat Bahari & Lai Ming Ling, Introducing Tax Education in Non-Accounting Curriculum in Higher Education: Survey Evidence, *Journal of Financial Reporting and Accounting*, 7 37-51 (2009).

⁶ R Amoah et al., An Investigation into Tax Evasion in Ghana, *International Journal of Empirical Finance*, 2(3) 115-22 (2014).

⁷ R Hastuti, Tax Awareness and Tax Education: A Perception of Potential Taxpayers, *International Journal of Business, Economics and Law*, 5(1) 83-90 (2014).

should be made mandatory for all students. This implies the importance of ethics in tax compliance.

Al-Maghrebi et al. (2016)⁸: The research posits that tax education has an essential role to play in ensuring tax compliance. This education will not only aid taxpayers in becoming better acquainted with the tax administration system but also help in enhancing transparency in the whole process. Transparency is especially important since previous studies indicate that citizens feel justified in evading taxes if they believe that the current system is ridden with corruption and other malpractices.

Wadhwa & Pal (2012)⁹: The researchers investigated the opinions of tax professionals such as CA, CS, etc regarding tax evasion in India. The study encompassed 180 respondents, and the responses were collected using a five-point Likert scale. They concluded that high rates of taxes, rampant corruption in the public sector, and inefficient tax authorities were some of the factors behind taxpayers evading taxes.

Pirttila (1999)¹⁰: The paper explored tax evasion in transition economies, particularly the Russian economy. They suggested the imposition of heavy penalties for default in paying taxes and a strict audit system to instil a sense of fear in the minds of taxpayers. This will help in achieving deterrence. The paper also stated that there should be a correlation between the tax policy and the public expenditure of the country.

Murphy (2008)¹¹: The paper studied two approaches to ensure tax compliance. These were deterrence based and accommodative. It was observed that while a deterrence-based approach involving strict penalties and rigid guidelines proved to be successful in the short run, in the long run the taxpayers developed some level of resistance and they were no longer effective. However, an accommodative approach based on cooperation and transparency encouraged people to voluntarily pay taxes.

Kumar et al. (2020)¹²: The researchers laid down three common ways by which citizens try to reduce their tax liability. These are: tax planning, tax avoidance and tax evasion. Tax planning is legal and moral and it involves planning your economic affairs in such a manner

⁸ Al-Maghrebi et al., Budget Transparency and Tax Awareness Towards Tax Compliance: A Conceptual Approach, 10(1) 7 (2016).

⁹ L Wadhwa and V Pal, Tax Evasion in India: Causes and Remedies, *International Journal of Applied Engineering and Research*, 7(11) 117-23 (2012).

¹⁰ J Pirttila, Tax Evasion and Economies in Transition: Lessons from Tax Theory, *Bank of Finland Institute for Economies in Transition* (1999).

¹¹ K Murphy, Enforcing Tax Compliance: To Punish or Persuade?, *Economic Analysis & Policy*, 38(1) 113-35 (2008).

¹² Kumar et al., Causes of Tax Evasion and Avoidance-Facts from NCR of India, 4 1-16 (2020).

that you are able to avail the maximum tax benefits. Tax avoidance refers to taking advantage of the loopholes in the rules and regulations, even though it is legal, it is highly immoral since it is in contradiction to the objectives of the tax administration system. Lastly, tax evasion is reducing one's tax liability by employing illegal means.

Fagbemi et al. (2010)¹³: The paper sought to understand the perception of the taxpayers in Nigeria towards their taxation system. The results were in line with other studies conducted in similar fields, since it showed that tax evasion would be higher when the government is corrupt. This further indicated the role of government in ensuring tax compliance. A government must conduct its operations ethically. Furthermore, better human right treatment and optimal tax rates are essential to combat tax evasion.

Sezgin et al. (2011)¹⁴: The researchers examined the ethics of tax evasion in Turkey and Kyrgyzstan. A survey consisting of 18 statements was circulated amongst students and it was found that Turkish students were more opposed to tax evasion as compared to Kyrgyz students. The study also revealed that Turkish female students had greater ethical values whereas Kyrgyz male students had higher moral values. This indicates the role of gender in ethics and morality.

Siahaan (2012)¹⁵: The paper investigated the influence of tax fairness and communication on voluntary compliance. The study was conducted in Surabaya, East Java. There were 61 respondents which belonged to the service industry. The results show that tax fairness has a significant impact on voluntary compliance of taxpayers. Secondly, it was observed that communication didn't really have an impact on compliance. The paper also provides suggestions as to how the problem of tax evasion can be reduced.

Uslaner (2010)¹⁶: The study explained the problem of tax evasion with reference to transition economies. The conclusions were in line with several other studies in the field. Exploring the psychology of people and their motivations for compliance, the paper stated that people are less likely to pay taxes if they believe that their money is going in the pockets of corrupt government officials. Thus, it is the responsibility of the government to build trust in their citizens and show results of the tax money that they are receiving.

Batra (2014)¹⁷: The research investigated the opinions of tax professionals on tax evasion in

¹³ Fagbemi et al., *The Ethics of Tax Evasion: Perceptual Evidence from Nigeria*, 17(3) 12 (2010).

¹⁴ Sezgin et al., *The Ethics of Tax Evasion: A Comparative Study of Turkey and Kyrgyzstan*, *Journal of Applied Business and Economics*, 12(3) 75-90 (2011).

¹⁵ Siahaan, *The Influence of Tax Fairness and Communication on Voluntary Compliance: Trust as an Intervening Variable* (2012).

¹⁶ Uslaner, *Tax Evasion, Corruption, and the Social Contract in Transition*, (2010).

¹⁷ P Batra, *Tax Evasion – An Evil for The Economy*, 10 (2014).

India. It also enumerated some causes of tax evasion, which are: high tax rates, corruption in public sector units, multiple tax rates and inefficient tax authorities. In the same vein, the paper also gave some valuable suggestions to increase tax compliance. These include: simplification of tax administration system, revising tax laws so as to remove loopholes and increasing tax literacy among younger generation of citizens.

Alm & Torgler (2011)¹⁸: The paper posits that the problem of tax compliance is some way can be explained by the neglected consideration of “ethics”. People do not always behave in a selfish and rational way to protect their own interests. There are various other factors, both external and internal which affect individual taxpayer behaviour. Hence, in order to gain a holistic understanding of an individual’s tax compliance decisions, ethics and morality cannot be ignored. Furthermore, morality and ethics are intangible, abstract concepts which operate on a spectrum. Which means that they differ from person to person. The paper suggests that ethics and morality have to be used along with traditional penalties to improve tax compliance.

II. FACTORS CAUSING TAX EVASION

Ogundele has defined taxation as “the process or machinery by which communities or groups of persons are made to contribute in some agreed quantum and method for the purpose of the administration and development of the society.”¹⁹ While it is agreed that taxes are necessary since they form a significant portion of government revenue, tax evasion is on the rise. Previous studies show that there are mainly two kinds of reasons as to why people evade taxes. These are either because there are deficiencies in the taxation system or because of reasons pertaining to taxpayers.²⁰

Some deficiencies in tax system could be: corruption in tax administration, inefficient government officials, weak tax laws that people can easily exploit and lastly unnecessary complications in tax collection process.

Tax evasion is such a huge problem that it becomes necessary to understand the taxpayers’ point of view, that is, their justifications for tax evasion. This is in turn connected with the ethics of tax evasion. Some internal factors such as lack of tax education, ethics of taxpayers, and high tax rates leading to a huge burden on the taxpayer can also lead to tax evasion.

An interesting study researching the ethics of tax evasion in Nigeria found that most people are

¹⁸ J Alm & B Torgier, Do Ethics Matter? Tax Compliance and Morality, *Journal of Business Ethics*, 101(4), 635–51 (2011).

¹⁹ A.E. Ogundele, Elements of Taxation, (1st ed, 1999).

²⁰ Gordon Cohn, The Jewish View on Paying Taxes, *Journal of Accounting, Ethics & Public Policy* 1(2) 109-20, (1998).

against tax evasion, that is, they agree that tax evasion is inherently unethical and wrong. However, the study also revealed some arguments that respondents gave to justify evading taxes and most of them believed that tax evasion was justified if the government is corrupt and exploits its citizens for their own personal gain.²¹

Another study sought to analyse the opinions of tax professionals on tax ethics and compliance in India.²² While trying to explore the reasons and the arguments that taxpayers give to justify tax evasion, they found that a majority of the respondents agree that tax evasion is a major issue in India. However, they disagreed with the statement that tax system in India was highly inefficient and thus, it is not one of the reasons behind people evading taxes.

Furthermore, the study also showed that a lack of general morality and ethics in both the taxpayers and tax officers leads to an increase in tax evasion. Which means, that once again corruption is the root cause of all problems.

People generally believe that there will be no difference if they do not truthfully pay their taxes because there are so many other people paying them. Another reason leading to tax evasion is the low probability of getting caught. Which connects to inefficiency of tax administration system. A lot of people are also of the opinion that reducing tax burden by engaging in tax avoidance is ethical since it is not technically illegal. The study evaluated the opinions of two types of tax professionals, namely CA and article assistants and they found that since CAs are in direct contact with the taxpayers, they have a better understanding of the reasons they give to evade and/or avoid taxes.

Hence, reasons like “It won’t make a difference if I don’t pay taxes” indicate the ignorance of taxpayers and lack of tax literacy. The illuminating paper also revealed that majority of the methods of tax evasion arises from corruption and ineffectiveness on the part of tax officials in detecting malpractices.

The findings of the study by Kumar et al. showed top five explanations behind tax evasion, which incorporates complex annual expense structure, absence of motivations to legitimate citizens, need of more mindfulness/persuasive projects for paying income/corporate tax, Illiteracy of citizens, also, Inefficiency/indiscipline of duty organization division.²³ Altogether, 5 reasons of tax avoidance and evasion are featured anyway initial three parts represents 95.715% change.

²¹ *Supra* note 12.

²² Lodha et al., *Tax Ethics and Tax Compliance: Exploring the Opinions of Tax Professionals of India*, IUP Journal of Accounting Research & Audit Practices 16(4), 44–66 (2017).

²³ *Supra* note 11.

Since experimental examinations involving classical tax avoidance models regularly detailed predictable deviations from perfect rationality, social researchers inspired by tax behaviour have expanded their zone of exploration by zeroing in on consistence determinants outside the financial range (i.e., charge rate, review rate, punishment rate, pay). Subsequently, a complex of factors from psychology (attitudes, norms, perceptions), sociology (education, gender) or political science (fiscal policy, tax law complexity, voting) were considered as determinants of citizens' choices.

The paper by draws on the impacts of tax literacy (i.e., the degree of tax awareness and knowledge) on citizens' conduct with respect to tax compliance, featuring different systems utilized by public expense specialists around the globe.²⁴ As an overall pattern, expanding tax education among youthful and prospective citizens is favoured by a few tax professionals, since potential supporters must be acclimated with the necessities of assessment frameworks prior to entering the monetary market as representatives, independently employed or bosses. The utilization of media crusades, tax lotteries and online filling frameworks are incorporated also among generally utilized techniques.

III. ROLE OF MORAL APPEALS IN ENSURING TAX COMPLIANCE

The literature review indicated that there is a significant and direct relationship between the ethics and morality of individual taxpayer and their tax compliance. A higher value of ethics will lead to better tax compliance. Furthermore, tax literacy is also a very important factor affecting compliance. Proper tax education and awareness leads to better planning on part of the taxpayers which leads to greater compliance.

A study examined whether tax ethics and social norms actually play a role in taxpayer complying with all tax rules and regulations or whether they are just a rationalization of their self-interested behaviour. This study encompassed over 1000 Australians. The results were three-fold. First, there was a relation between tax ethics and compliance and the level of compliance varied by the ethics and morality of the taxpayer. Second, social constructs and norms affected individual taxpayer beliefs and that in turn affected their level of compliance. Last, these perceived norms casually affected tax compliance.²⁵

Hence it can be concluded from the above study that the role of ethics and morality in shaping individual taxpayer behaviour cannot be ignored.

²⁴ Ramona-Anca, N, Knowledge Is Power. Improving Tax Compliance By Means Of Boosting Tax Literacy, *Annals of Faculty of Economics*, 1(1) 770–74 (2015).

²⁵ Wenzel M, Motivation or Rationalization? Causal Relations Between Ethics, Norms and Tax Compliance, Australian National University Working Papers, No. 63 (2005).

Traditionally, common measures to reduce tax evasion follow the deterrent theory of punishment. This involves imposing a high penalty or other sanction to make an example out of the offender which will have a deterring effect on other potential offenders. However, when the risk of getting caught is low, a high penalty may not be enough to have a deterring effect.

This necessitates a new way of ensuring tax compliance. While, traditional sanctions are still important, government should look into how it could use ethics and morality to encourage taxpayers to voluntarily disclose their real income and abide by other guidelines.

A study by the Harvard Business Review investigated the role of moral appeals in reducing tax evasion. They sought to show how governments can tap into moral motivation of taxpayers and encourage tax compliance.²⁶

Their research involved a field experiment with the Norwegian Tax Administration on 15,000 tax-paying individuals. The test subjects were selected on the basis of the tax administration's knowledge or assumption that these group of taxpayers were more likely to underreport their foreign income. These subjects were randomly divided into two groups. One group did not receive any letter and the other received some kind of letter. There were two types of letters that were sent to these taxpayers: one was a simple "base letter" which contained instructions as to how to self-report one's foreign income and the other was a "moral letter" and a "detection letter".

The moral letters consisted of arguments as to why taxpayers should honestly report their income. Some of these arguments were based on ideas of fairness, while others were based on general societal benefit. The detection letter on the other hand, did not mention anything related to ethics, morality and "right thing to do", it just contained a caution that there was a possibility of being audited.

The results revealed that there was an increase in the self-reported foreign income just because of the base letter. This proves the importance of tax literacy and indicates that one of the major reasons behind tax evasion is lack of awareness of the laws, procedures and guidelines amongst the taxpayers. Another interesting finding was that individuals who received a moral letter were twice in number as compared to the base letter group to honestly report their foreign income.

The study also revealed that there was not any significant difference between the reporting of income by moral letter group and detection letter group. However, considering the feasibility of sending moral letters, it was observed that detection letters were far more effective in the

²⁶ Kristina Bott et al., [Research: Moral Appeals Can Help Reduce Tax Evasion](https://hbr.org/2017/07/research-moral-appeals-can-help-reduce-tax-evasion), Harvard Business Review, (July 20, 2017), <https://hbr.org/2017/07/research-moral-appeals-can-help-reduce-tax-evasion>.

long run.

The results of the Harvard study are in consonance with the study by Lodha et al. examining the role of ethics and morality in tax compliance. The respondents of the latter were tax professionals in India. They were of the opinion that it the moral responsibility of every citizen to pay taxes and at the same time the tax authorities should also be competent and effective. Work and cooperation from both the sides is required to combat the problem of tax evasion.

Individual moral beliefs are highly significant in tax compliance decisions and ethics are a very important part of the Indian culture.²⁷ The findings of the study showed that if individuals perceive tax evasion as an unethical practice, they are less likely to evade them irrespective of their financial situation. A large majority of respondents agreed that everyone should pay taxes without a fuss and disagreed with the statement that tax evasion is justified on the ground that it only hurts the government and individual interest is protected. In short, people's moral compass generally tells them that tax evasion is not the right way of reducing one's tax liability.

IV. CONCLUSION

In conclusion, tax evasion is a serious problem having long term effects on the growth and development of an economy. To reduce the same, the need of the hour is to apply some new ways of motivating taxpayers to voluntarily abide by the tax laws of the country.

Tax avoidance and tax evasion are a social hazard that is making a significant misfortune the monetary advancement of India. From all signs, it is currently certain that if the public authority takes part in redesigning the tax administrative machinery, the issues of tax avoidance and tax evasion will be decreased to the barest least. It is likewise significant for the focal government to force solid punishment on corrupt authorities and guarantee implementation of law to debilitate charge defaulters. Such punishments and implementation of law will help add more income to the coffers of the public authority. These proposals will assist with controlling the outside components answerable for tax avoidance, however, not the internal components, for example, justifications and intentions.

Consequently, a moral culture towards tax compliance ought to be sustained. Citizens and expense specialists should initially enquire themselves if what they plan to do is moral, as opposed to whether it is legitimate or then again not. Moral qualities ought to be utilized to help adhere to a meaningful boundary in choosing what can or can't be never really charge instalments.

²⁷ *Supra* note 21.

Hence, moral appeals should be incorporated to some extent to reduce tax evasion. A combination of both sanctions and such appeals is required, since, appeals may only work in the short run only for some individuals. This shortcoming can then be solved by traditional penalties.

Combating the problem of tax illiteracy is also very important because it shows that the reason behind a lot of taxpayers not complying with tax laws is not because they wish to reduce their liability but because they are not aware of the rules and procedures of self-reporting. Instituting tax education in higher education schools for students coming from different backgrounds is required. These measures will help in cultivating an ethical culture towards tax compliance and taxpayer behaviour.
