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## Tax evasion in a transition from socialism to capitalism: The psychology of the social contract

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# BOFIT

## Discussion Papers

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2000 • No. 6

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**Martti Vihanto**

Tax Evasion in a Transition from  
Socialism to Capitalism:  
The Psychology of the Social  
Contract

Bank of Finland  
Institute for Economies in Transition BOFIT

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## Contents

Abstract .....	5
1 Introduction .....	6
2 The decision to evade as rule following .....	8
3 The attainability of a unanimous tax contract .....	12
4 The link between contract and compliance .....	16
5 The problems and legacy of socialism .....	19
6 Means to increase tax compliance .....	26
7 Conclusions .....	29
References .....	31

All opinions expressed are those of the author and do not necessarily reflect the views of the Bank of Finland.

Martti Vihanto \*

## Tax Evasion in a Transition from Socialism to Capitalism: The Psychology of the Social Contract

### Abstract

In a common assumption of the economics of tax evasion, extending beyond the basic Allingham-Sandmo model, the choice of a taxpayer to evade taxes depends upon the perceived fairness of the tax system. The purpose of the paper is to provide a psychological foundation for this assumption by drawing on Hayek's theory of human behavior as a process of rule following. According to the main hypothesis, taxpayers are more compliant with tax laws to which they can in principle give their full consent. A social contract as a basis of tax policy may provide a potent means to combat tax evasion particularly in transition economies that have inherited a deep mistrust of the government from their socialist past.

**Key words:** tax evasion, social contract, economics of psychology, transition economies, Austrian economics

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## 1 Introduction

When describing the decisions of taxpayers to evade taxes, economists model the decision-making process almost invariably as an act of optimization. Central to this approach, customary throughout modern economic analysis, are the intertwined assumptions that human beings have a structured, though not necessarily complete, knowledge of all the facts relevant to their decisions, and that they possess unlimited cognitive skills to process all that information. In the rudimentary model of Allingham and Sandmo (1972), the taxpayer is assumed to know how to maximize his or her net income through rational balancing of the probability of being caught for evasion, the expected penalty, and the degree of risk aversion. Many recent scholars, such as Cowell (1990) and Andreoni, Erard and Feinstein (1998), continue to consider the model a good starting point.

Economists make excuses for the assumption of optimization, known as untrue even on the basis of superficial introspection, on the plea of an argument that Friedman (1953) forcefully made a half century ago. He declares that it is an acceptable, even desirable, procedure in economics to start a logical deduction from unrealistic assumptions as long as it produces hypotheses with a sufficient predictive power. Ultimately, he notes, the scientific merit of an economic theory is not established by checking correctness of assumptions, but by subjecting predictions to severe empirical testing.

The conventionalist approach has probably never worked as impeccably as some of its idealist proponents might have hoped. In the economics of tax evasion, the approach has a particularly poor record. For starters, there are no reliable statistics on those who evade taxes, or even the amounts evaded, because the obvious intent of such evasive activity is to prevent authorities from ever learning the details (Cowell 1990, 26). In the light of the modest progress in measurement techniques, as reported by Tanzi (1999, 339), there are few hopes of any betterment. Since Friedman's (1953, 31) observation, economists have looked skeptically upon surveys that question economic actors about tax evasion. Interviewees have good motivation to deliberately understate the extent of their evading behavior for fear of revealing truths with legal consequences. They may also change their stories if they feel guilty about breaking the law (Weigel, Hessing and Elffers 1987, 217). Moreover, laboratory experiments that put subjects into artificial settings and induce them to act differently than they would in their customary surroundings may

provide unreliable results (Hessing *et al.* 1988, 519). The available evidence, such as it is, suggests that the Allingham-Sandmo model strongly over-predicts the extent of tax evasion, at least in Western democracies (Andreoni, Erard and Feinstein 1998, 850), and, therefore, fails at both ends of its chain of reasoning.

Partly in response to the poor predictive power of the basic economic model and partly due to the need to make it somehow testable or scientific, students of tax evasion have modified many of the model's assumptions so as to more closely align them with known reality. Tax compliance is assumed to increase, for example, when taxpayers feel guilt or shame for breaking the tax code (Erard and Feinstein 1994), when they regard the fiscal system as basically fair (Cowell 1992), or when they observe other taxpayers comply (Myles and Naylor 1996). A problem with all these attempts to upgrade assumptions is that the conceived traits of human behavior remain unexplained or exogenous, making it impossible to verify the consistency of the assumptions. To find factors that affect tax compliance and determine how they change over time and how they interact, we must apply a rigorous analysis of human psychology, rather than state *ad hoc* assumptions. Such an approach may benefit economic theory and help tax policy makers by providing tools that go beyond simply treating the symptoms of tax evasion (Lewis 1982, 127).

The purpose of this paper is to develop a psychological theory of tax evasion. Unlike the basic model, we assume taxpayers are unable to optimize their behavior due to their limited knowledge and cognitive skills. In section 2, I note that real-world taxpayers tend to follow rules they know or trust to have produced good results in the past. Honesty can be a highly useful rule in many situations, and taxpayers may follow it, due to effective conditioning or failures of discrimination, even when dishonesty would better advance their private interests. I argue in section 4 that "honesty mode" tends to be activated when taxpayers can agree on the tax laws and, before this in section 3, that such unanimous consent of taxpayers is in principle attainable under certain conditions. The chances of tax legislation compatible with a conceptual tax contract for evoking compliance are exceptionally good in transition economies, which have inherited socialist-era legal systems glaringly devoid of general approval. In section 5, I explicate the main aspects of the socialist economy that account for the discrepancy. Combining the findings, section 6 gives practical suggestions that authorities in a transition

economy might use to discourage tax evasion.

The analysis throughout the paper is confined to personal income tax. Admittedly, income as a tax base likely carries limited fiscal weight early in the transition process, but it inevitably grows in importance over time. While the government can obviously lose revenues from income tax as a result of cheating on the part of individual taxpayers as well as firms enjoined to do the withholding, attention here is paid solely to the evasive motives of taxpayers.

The inspiration for most of the subsequent analysis goes back to the inquiries into social reality by scholars in the Austrian school of economics. The notion of decision-making as a process of rule following is based on the psychological theory Hayek advances in *The Sensory Order* (1952). The view of a social contract, approved by all members of a society, as the foundation of welfare economics is based on the contractarian theory of Buchanan (1959), whose emphasis on subjectivism shares many elements cherished by the Austrians. The critique of socialism put forth by Mises in the 1920s with amazing foresight (Mises 1936) and further developed by Hayek in the 1930s (Hayek 1948) informs most of my examination of the problems of transition economies. The argument throughout is influenced by the theory perfected in particular by Kirzner (1992) of the society as an open-ended process of discovery (Vihanto 1995).

## 2 The decision to evade as rule following

The decision of a taxpayer to evade personal income tax typically manifests itself as undeclared earnings, perhaps from occasional sources, and as exaggerated deductions in the tax return. The best opportunities for such cheating are available in self-employed trades and professions where the income is not subject to withholding taxes and there are many warranted deductible expenses. The purpose of this section is to inquire into how the decision to evade is reached. Since one aim of the analysis is to convince the proponents of the conventional economic approach that the assumption of optimization is not necessarily useful for understanding human actions, we consider an unusually ignorant taxpayer, clearly incapable of optimization strategies. This individual could be, for example, a youngster entering the working life who has never before been liable for income tax, an adult who has recently immi-

grated from a country with different tax laws, or a citizen of a socialist commonwealth that has never been subject to personal income tax.

According to Hayek (1952, 37-54), an actor, like the taxpayer in our example, aims to grasp a situation by comparing it to similar situations he has personally experienced or knows about (Vihanto 1998). A case may involve a large number of aspects, ranging from vital to trivial, and it typically evokes memories that share some common elements with the case at hand. The taxpayer's memory contains classes of events with which he strives to match the current event to get a hint of which might possibly be his best choice. At one extreme, the classes are very broad, capable in consequence of suggesting actions of a most general nature, and at the other extreme, highly confined, with an almost ready answer to the taxpayer's dilemma. Simon (1996, 88) describes long-term memory as a limitless encyclopedia or library in which the information is stored by topics, liberally cross-referenced and outfitted with an elaborate index.

The action that the taxpayer eventually chooses as a result of the classification process may not be an exact replica of any of his previous actions or any of which he is aware. The action, nevertheless, shares at least some elements with earlier actions, or, to use another expression, belongs to a class of actions stored in memory. When a person is disposed to act in a specific way in situations that are different but include common elements, he is in the terminology of Hayek (1963, 44) following a "rule." Under this definition, rules are not pre-existing norms like tax laws codified in the Statute Book or moral precepts written in the Bible, but rather largely unintended products of complex mental activity that draws upon vast tacit knowledge and evolves over time.

The foundations on which people base their decisions are often rather flimsy, an aspect we wish to bring out in our example. The sample of the past experiences having any relevant resemblance to the current situation may be small, the advice conveyed by the cases may be inconsistent, and one may fail to retrieve, or confuse, crumbs of knowledge one happens to possess. Against this background it is hardly surprising to find that people try to get out of the agony of decision-making by imagining causalities where none exist and by denying evidence in conflict with their first intuitions (March 1994, 89; 84).

Using the psychological theory outlined above, the taxpayer decides to evade taxes, or follows a rule of tax evasion, when such behavior pro-

duced good results in the past. The taxpayer may have learned, for example, that there are no audits even when he hides most of his earnings or, if he is subject to an audit, the consequences are trivial. The uninformed taxpayer in our example may not personally have such experience, but he may rely on what he is told by friends who have cheated successfully in the past or have otherwise given him reason to believe that he can profit from cheating. Lacking such second-hand knowledge, the taxpayer falls back on general rules he finds judicious, for example, a norm promulgated in society that one should not violate the tax laws. Of course, there always exists the alternative of a random trial-and-error approach that holds out hopes of a better adaptation. As Simon (1983, 41) warns, however, even the first trial may produce in some cases a catastrophic result, eliminating any chance of correcting behavior over repeated trials.

We have assumed so far that, because of his incomplete information, the taxpayer resorts to backward-looking or roundabout procedures of rule following, instead of aiming to achieve his ends directly through optimization. Limits on the cognitive capacity of the human mind also give cause for rule following. For example, a person intent upon solving Rubik's cube has at her disposal all the information needed for finding an optimal solution to the closed-ended puzzle, but leans nevertheless on rough rules of thumb due to her limited competence to process that information (Heiner 1983, 564). This explains why the novice to a game may go through a long losing streak while she gradually learns the rules through experiment and imitating the actions of more experienced players.

An important incentive for people to imitate each other's actions, be it for incomplete information or cognitive limits, is the intent to gain advantage from the repertoire of rules others have managed to accumulate during their lifetime. Often the advantages are mutual and the imitated person benefits as much, or even more, than the imitator. The benefits from shared rules can even spread throughout an entire group, which can be anything from one's family or circle of friends to the personnel of a large corporation or, as I argue later, the members of a society.

There are several reasons why it is of advantage to any one member of a group that the others follow at least in part the same rules and foster a roughly similar understanding of the world around them. First, people that follow similar rules are better able to understand each other's actions (Hayek 1963, 59). For example, a tax officer assigned to help taxpayers asking for counsel

has a fair chance of serving her customers, when they share her comprehension of the meaning of certain language, agree on the logical qualities in the tax system and, more generally, form a mutual idea of surrounding events.

Second, shared rules make it easier for the members of a group to predict each other's future actions (Hayek 1973, 97). For example, merely knowing the party of a candidate for parliament may be enough for a voter to make fairly reliable predictions about the general direction in which the candidate, if elected, would reform the tax system. On the other hand, the members of the parliament belonging to a party on the opposite side of the political spectrum may have genuine difficulties in following the train of thought of the candidate. In debates, such persons might speak past each other, act as if they live in different worlds, and fail to anticipate the other's motives and behavior.

Third, individuals with shared rules are in a better position to resolve conflicts between themselves than members of divergent groups (Hayek 1960, 114). Let us assume two fellow workers of little acquaintance happen to meet Saturday night at a downtown pub. After quaffing a few beers, they start arguing about whether families with children are entitled to a special family deduction on their income tax. One worker grew up in a large family. His parents sweated constantly about money, and he himself now supports numerous under-age dependents. The other worker is an unflinching bachelor with few married acquaintances, well aware of the costs of single living. In such a situation, the chances of a fistfight seem more likely than the likelihood of the two quickly reaching a common view.

Fourth, rules shared by any two individuals facilitate their efforts to make use of opportunities for cooperation (Denzau and North 1994, 20). For example, a self-employed carpenter proposes to one of his customers a transaction without a receipt for the purpose of evading taxes. The deal is obviously easier to put through when both have previous experience of evasion, know many other people who cheat as soon as an opportunity arises, or patronize the same bent accountant. Langlois and Foss (1999, 209) argue that the obstacles to trade brought about by differences in ways of thinking also affect the "make-or-buy" decisions of firms and constitute a usually ignored element defining the boundaries of firms.

People have a natural tendency to follow the same rules as the members of groups with which they share common affinities. March (1994, 70) argues that the mere physical presence of members of such groups may be

enough to evoke modes of behavior specific to the context. At times the members of a group share conceptions of the world that are completely erroneous and, as Halpern (1998, 224-225) argues, consider deviations from them irrational to the great astonishment of the members of other groups. For example, they can earnestly believe, contrary to the facts, that most others are evaders, making their beliefs self-fulfilling (Porcano 1988, 64) and frustrating, like in the famous Keynesian beauty contest, attempts to determine the “equilibrium” of the game (O’Driscoll and Rizzo 1985, 74). As a result of group behavior, the disposition to tax evasion tends to spread in a society, or the constituent groups that form the society, once the behavior has had time to gain a foothold. To borrow imagery common in the literature on financial crises, taxpayers are prone to “herd behavior” roughly like bank depositors, and tax evasion tends to be “contagious” in a way similar to bank runs.

The decision of a taxpayer to pay taxes and refrain from tax evasion is an expression of a disposition to follow a more general rule of honesty and hold to one’s commitments. The behavior of others has an influence for reasons just stated, but the expectation of getting private benefit from acting honestly certainly remains the fundamental *explanans*. One arena where people learn the value of honesty is in contractual relations where breaches of contract lead quickly to a loss of future trade with the cheated parties. This advantage of honesty is not so self-evident in the case of taxation because taxes are compulsory and evasion is seldom a cause for denying access to public services. Even though taxation cannot be a product of a genuinely voluntary agreement among the taxpayers and the government, we might conceive of it as emerging from a *conceptual* social contract that the taxpayers are in principle able to give their unanimous consent. We examine in section 4 why tax laws compatible with such an imaginary construction may greatly enhance tax compliance and, in the next section, when agreement on rules of taxation is possible.

### 3 The attainability of a unanimous tax contract

It is a common practice in modern tax theory to adhere to the utilitarian dictum, whereby, in order to be “good” in a moral sense, the rules of taxation ought to be chosen to maximize total welfare. Economists with a subjectivist leaning, such as the proponents of the Austrian school, do not approve of this

normative point of departure on the ground that both goodness and welfare are inherently subjective notions that resist reliable measurement by any scientific standards. Buchanan (1959, 108) takes the subjectivism of values seriously and argues that for others to find out what any one individual considers good and worthwhile, the opinion must be revealed by overt action. Since tax laws affect all the members of a society, everyone's expressed consent is required to them or the constitutional rules under which they are enacted, and the laws have thus to meet at least indirectly with unanimous approval (Vihanto 1999). The purpose of this section is to examine the general principles of designing tax laws that provide, according to contractarian logic, the only legitimate basis for normative explorations of welfare economics.

Taxes are a taking of private property for which the morality of natural law, deeply rooted in our conceptions of right and wrong, entitles the owner to a just compensation (Epstein 1985, 100). It is entirely conceivable, as for example Hayek (1979, 44) intimates, that the participants in a social contract expect adequate indirect benefits from taxation, such as police protection of their property and public health services, that they renounce in concert their natural right to compensation. Taxes are an unavoidable evil (Mises 1936, 445), and a society with modest taxation is undoubtedly far better than one without any taxes.

The most precarious part of the tax contract is the government, which serves as the agent liable for enforcing the tax rules and is entitled to use force toward this end. Monopolies are always potentially harmful, as economists will readily bear witness, and the monopoly of force is evidently the most dangerous of all. An elementary requirement for a unanimous tax contract, therefore, is the implementation of a system of checks and balances that effectively constrains the taxing power of the government (Brennan and Buchanan 1980, 32). Constitutional constraints are for the government a credible promise not to abuse its power to tax, essential for the purpose of gaining that power in the first place. As long as people make the government abide by the constitution, taxation ceases to be "legal robbery" of the kind envisioned by Rothbard (1978, 51) and turns into a set of obligations similar to, though with much greater extent than, those agreed upon by contracting parties in business life.

An actual tax contract between the government and citizens is probably unfeasible because of prohibitive contracting costs. Moreover, even if the participants in the bargaining process succeeded in reaching perfect una-



nimity, the outcome could still be questioned on moral grounds and the goodness of the tax laws would remain dubious. First, the results of contracting always depend on the *status quo* of the participants, and insofar as no state is morally superior to others, the results are equally indefinite (Rothbard 1976, 97). The starting point matters not only because it affects the bargaining position of the participants, but also, as noted by March (1994, 22), because it affects their aspiration levels. Second, morality is generally thought to be something more elevated than merely confirming what the people consider appropriate at a particular moment (Hardin 1988, 114). In spite of the problems with contractarianism, only touched on here, I go on and examine in the following what the rules of taxation and the persons trying to reach an agreement on them ought to be like to make a unanimous tax contract conceptually, though not strictly in practice, attainable.

A basic requirement for tax contracting is that the participating individuals know enough of the general consequences of the alternative tax rules to make a rational choice, but not enough of the specific consequences on themselves (Brennan and Buchanan 1977, 370). Knowledge of the general characteristics of the tax systems under consideration is a public good, and individuals are likely to make decisions in abundant ignorance of them. An indication of such rational ignorance is the frequent finding of surveys that taxpayers have conspicuously scanty knowledge of the marginal rates of income tax in force, the share of the tax revenue currently expended on armed forces, and other similar fiscal particulars (Furnham and Lewis 1986, 222-230). An effort toward solving the problem of uninformed constitutional choice is to limit the choice to general principles of justice and delegate the later decision on particular tax rules to the government.

Further, the participants in tax contracting are incapable of making perfect constitutional decisions even when they have appropriate incentives to acquire the necessary information. The world is too complex for people to ever have perfect knowledge of it, and, even if they somehow miraculously had access to such knowledge, their mind would be inadequate to process the information. A special problem, pointed out by Hayek (1960, 112), applies to contracting from novel tax rules, first approved by a few and gradually endorsed by a majority. It was argued in the previous section that people cope with their informational and cognitive limitations by following rules proven to have worked in the past. The tax contract thus emerges as a combined outcome of the parties following tried and found rules of action.

The decision to endorse or oppose a progressive income tax provides an example of rule-based decision-making. People may not support the notion of progressivity, if it turns out to be insuperably difficult to enforce due to systematic tax avoidance by the well-to-do. Under certain circumstances, even a flat tax may be impracticable, so the shift to a different type of tax that is less troublesome to collect, like an import duty, may be preferred. When the contracting individuals have lived for decades in a socialist society where the tax system has been altogether different, there is little to do besides draw on the experience of market economies and learn to adapt that experience to domestic conditions. Tax system designers should probably not be overly anxious about the occurrence of tax avoidance and the deadweight loss associated with it. Attempts to ward off such behavior may make it seem as if it were legitimate and, as Musgrave (1992, 373-374) remarks, undermine the moral foundation and general respect for the contract.

One of the first lessons taxpayers learn is that the consequences of a new tax law are always to some extent unexpected, and may occasionally give rise to complete surprises. Entrepreneurial taxpayers invariably discover new ways to avoid taxes, to notice market opportunities that enlarge or reduce the tax base, and to have other effects on taxation. Indeed, given the open-ended nature of the social process, the unintended long-run consequences can never be foreseen in all their ramifications simply on the basis of currently available information. For example, it is hard to predict the extent to which tax evasion might proliferate on a permanent basis as taxpayers realize to protect their property after a temporary tax increase. A means to keep down evasive entrepreneurship advanced by Elffers and Hessing (1997, 297) is to offer taxpayers the choice of an overall standard deduction that makes them less interested in devising cooked-up deductions. A wise policy for tax policy makers in the dynamic conditions of spontaneous discovery is to proceed tentatively, keeping an eye on reactions, while holding the back gates open if the need to abandon the project arises.

Kirzner (1985, 94) and other proponents of the process view stress that the chances of those partaking in the tax contract of making allowance for the adverse effects of a heavy tax are weakened by the fact that the effects may remain forever hidden. It is fully conceivable that the tax discourages an entrepreneurial market participant from discovering something truly novel that leads to a loss no one misses. An example of the failure to see the remote effects of taxation is the frequent temptation to tax luxuries which briefly

satisfy the caprices of a few rich but, as Hayek (1960, 43) notes, may become eventually, after a chain of persistent entrepreneurial innovations, the ordinary stuff of the masses.

While limited in their incentives to inquire about the overall working of the tax rules, the contracting individuals have a stronger motive for finding out the effects of the rules on their own well-being. The basic stratagem for avoiding the conflicts such self-interested pursuits bring to tax contracting is to search for tax rules that are general enough to make a prediction of their individual effects impossible (Brennan and Buchanan 1985, 29). The idea behind such tax rules is to define by help of abstract attributes, or in terms of classes, who pays taxes and how much, and to put off the classification of concrete cases until the post-constitutional stage of day-to-day dealings. Obvious further properties of general rules, mentioned by Hayek (1960, 208-209), include that they are well known by the public, unambiguous, and applied equally for long periods of time. The rules of the tax contract resemble the personal rules of the mind examined in the previous section in that both are discovered through spontaneous learning and have an influence on only some aspects of human behavior. Tax rules, however, are laws that must be stated in writing.

So far we have looked at a tax contract unanimously agreed upon by the members of a society as a means to find out which tax laws are good in the view of the people and the kinds of taxation the government is thus morally justified to enforce. My main motivation for discussing the issue at such length lies in the fact that a tax contract can also enhance the commitment of the parties to comply with the tax laws and thus reduce the extent of tax evasion. Reasons emanating from the psychology of rule following for this quality of the tax contract are examined in the next section.

#### 4 The link between contract and compliance

The primary means to make the people pay their taxes is to use the apparatus of compulsion at the disposal of the government. This is a tool of both a benevolent government designing the system of taxation on the basis of a utilitarian calculus, and an autocratic government collecting arbitrary taxes with its own interest in view. A government intent upon enforcing tax laws conforming with a tax contract does not dispense with force, but is greatly

assisted by the self-enforcing properties of the tax contract. I assume with Fauvelle-Aymar (1999, 398) that an opposition to taxes is a manifestation of an opposition to the government itself, and lessening this opposition demands a political authority meeting with voluntary acceptance.

I argued in an earlier section that people remain honest and keep their promises in fear of losing trade in the future with the cheated parties. In the case of the tax contract, this mechanism is, strictly speaking, not operative. A breach of the tax laws affects such a large number of other taxpayers that no one has the incentive or information to stop doing business with the evader, put him to shame or punish him in some other way. There are several reasons, nonetheless, why the tax contract retains some of the qualities of contracts in the small-group context and induces the participants to pay heed to their reputation as respectable taxpayers.

First, due to limitations on their information and cognition, people may be unable to distinguish the contracts where compliance is privately profitable from those where it is not. They are following the rule of honesty, useful in certain situations, in cases of another kind that share some common aspects but are still so different as to make the following of the rule irrational (Bazerman *et al.* 1998, 90). “Anomalies” of this kind are common in human behavior, and since they are connected with rule following as a general phenomenon, strong incentives exist to overcome them. For example, persons who have lived for generations in small villages with strong social ties may try to shake off their moral inhibitions as soon as they move to a large faceless city. One might expect on these grounds systematic differences in tax morale by age groups in societies where internal migration from countryside to urban surroundings has continued long on a large scale. A further inducement to get rid of errors is the deliberate attempts of others to take advantage of them (Frey and Eichenberger 1994, 219), such as the government aiming to enhance tax compliance by the publication of embroidered statistics of evasion.

Second, while conditioning their children to keep promises, parents are often bound to do it in a general fashion without discriminating too much between the types of the commitments. As a result of such generalized education, the children tend to keep their promises later in their life in many cases against their own interests and contrary to their parents’ intentions (Vanberg 1994, 57). For example, the parents may teach honesty in the context of dealings among family members, but the disposition they want their

offspring to embrace leaks to other fields of life where more circumspection would be advisable. Reaching adulthood, these children take the “identity” of acting honestly in the family circle to relations with those in their working places, the parties to the tax contract and any other people they feel to be in an agreement with. A person conditioned to act honestly suffers feelings of guilt while evading taxes agreed upon in the tax contract or straying otherwise from his disposition, and his nature as it were forces him to act against his private interests. A hyper-honest taxpayer might so fear suspicion of cheating that he omits deductions an auditor might examine or even exaggerates his income. A further effect of the psychic cost connected with tax evasion is that, if a fraud is nevertheless once committed, a honest person might try to deliberately block his transgression from memory. Such self-deception is most likely in a labyrinth of taxation difficult to understand and gives a cause for simplifying the tax system (Lewis, Webley and Furnham 1995, 237).

Third, people tend to pay taxes they have consented to, in contrast to those imposed on them from above, because such taxes confer a feeling of self-determination. Frey (1992, 166) mentions this feeling as one that enhances the “intrinsic motivation” of human beings, making them perform an act without any other reward except the act itself. In a plausible line of argument, the seemingly irrational disposition emerges as a result of actors learning that they benefit more from fulfilling commitments they entered into voluntarily, rather than through coercion.

There are many other instances, besides duress, in which holding to one’s side of the bargain is unlikely to hold private advantage. For example, a man marrying a woman who fails to do her part can expect few benefits and a lot of trouble if he keeps to the contract. Indeed, once the other party is in breach, the desirable strategy is probably deliberate non-compliance to provoke an end to the relationship. Here, there is a *hope* of lost trade in the future. The disposition to reciprocate cheating, known to produce more often than not good results in ordinary contracts, may spill over into the sphere of taxation. From the point of view of strict individual interest, it is, of course, not more profitable to pay taxes solely on the model of how the others happen to deal with their tax liability. A plausible explanation for the rule of reciprocity, simply taken on assumption by Sugden (1984, 775) and others, is that, due to limitations on their information and cognition, taxpayers are unable to ascertain without mistakes when cheating by others should evoke non-compliance and when it should not.

The reasoning above produces a prediction similar to the intuitive assumption of Cowell (1990, 109), Myles and Naylor (1996, 52) and other students of tax evasion that the decisions of taxpayers to comply depend on the extent of compliance they observe around them. The tendency of evasive behavior to spread in communities is further reinforced by the disposition of taxpayers, as noted earlier, to mimic the actions of each other. The influence of others is particularly strong in small groups where shared rules are followed as taxpayers and in numerous other roles. Once tax evasion takes on large dimensions in a society, a compliant taxpayer may feel like an exploited fool and join the evaders. While designing tax policy, the government needs to bear all these considerations carefully in mind. Worries about tax evasion are less urgent insofar as taxpayers consider taxation to be in conflict with the tax contract, the kind of psychological obligations discussed here are absent, and illicit behavior has only a limited propensity to become epidemic.

In practice, of course, members of large societies are probably incapable of unanimously agreeing on a tax contract. Thus, contractarianism is essentially a way of thinking, and the tax contract itself is a fictive product of economic theorizing. Yet, even with the likelihood that societies adopt watered-down tax contracts, I assume that the reasons to enhance tax compliance retain some of their strength and provide grounds for the government to pass only laws that people can consent to, at least in principle. The need to pay heed to this contractarian notion and the benefits from doing so are nowhere as evident as in transition economies. Socialism, from which such economies inherit their legal and moral institutions, is in fundamental conflict with the common opinion of the people, leaving extensive distrust of the government and the legal system as a whole. An effective means to abate the consequent problem of tax evasion is to give people a say in the issues of taxation and evoke in this way the disposition to honesty just discussed.

## 5 The problems and legacy of socialism

Legislation in line with general approval is a basic means to increase obedience to the law. Even laws meeting the criterion of unanimity may not be observed without enforcement. An obvious further prerequisite for creating the desired behavior is a government that enforces the laws with adequate energy. There is always a risk that the powers of enforcement are used for

purposes not approved by the people. A final requirement is that the government keeps to its legitimate role and retains the kind of reliability in the eyes of its subjects necessary for a cooperative climate to develop. The purpose of this section is to show that none of these three conditions are met in a socialist society. The reasoning is heavily inspired by the evolutionary insight that when members of a society desire to alter the process of institutional change, they must start with the results of path-dependent processes the past has left them. They are prisoners of their own collective history. As a consequence of this legacy, a transition economy may be afflicted by its historical inheritance far into the future, suffering the same problems with compliance as the previous socialist economy.

Socialism here is defined as a social system in which most or all of the material means of production are owned by the state. Nationalization gives rise to a number of grave social problems that account for the poor performance of socialist societies, amply evidenced by historical experience and long foreseen on theoretical grounds by some economists. A rational use of the means of production requires that the owners, be they private citizens or government agents, have considerable freedom to decide on the employment of their possessions for alternative purposes. This usually causes no notable problems in a free market economy, where ownership of the means of production is decentralized and the owners of any particular means are compelled to compete with others for buyers. The case is different in socialism, where the government is essentially a monopoly beyond the reach of the disciplining forces of competition.

The discretionary power of the government to use the means of production in its possession generates a set of connected problems, all contributing to the economic and cultural decay of socialism. First, the day-to-day exercise of the power is impossible for citizens to monitor effectively, which invites the inevitable misuse of the available resources for the private purposes of government agents. Second, state power opens up ideal opportunities for various political pressure groups to seek favor with the government and further impair the allocation of the scarce resources. Third, and most important for a successful later transition to capitalism, citizens quickly lose trust in any government that acts in a discretionary or even despotic way, and cease to believe in a government under the law.

In the free market economy, the function of the government is mainly to enforce end-independent rules of law. The abstract purpose of such rules

is to enable the owners of private property to resolve their mutual conflicts of interest peacefully and to give rise to the unintended result of a spontaneous social order (Hayek 1973, 50). In a socialist society, in contrast, the application of laws always seems to be toward concrete ends, the laws look more like specific orders than general principles, and the will of the government appears to invade all conceivable sides of human life. When people accustomed to such a legal system try to agree upon the rules of taxation, they may fear that the government will squander the revenue, as before, on its own purposes, and that few benefits are to be expected in exchange for compliance with the tax laws. According to Buchanan (1997, 118), a major obstacle to a successful social reform is the persistent belief of people that doing one's share in a contract involves making sure that orders are meticulously fulfilled, without caring much about the reciprocity of the benefits. The hysteresis persists until the government gradually builds up reputation by credible commitments and proper conduct, and the people learn to view tax laws as the kind of general rules I described in a previous section.

The second set of problems arises from the informational and cognitive limitations of government agents, such as the members of a central planning board. In this respect, socialist planners are as fallible as their counterparts on the boards of free market companies. Perfect decisions on the allocation of productive resources are unattainable, because the needed information changes perpetually (Mises 1936, 105), much of it is tacit (Hayek 1948, 155) or beyond anyone's imagination before discovery (Kirzner 1985, 141), and it well exceeds the processing capacity of the human mind (Simon 1996, 34).

Whereas the planners both in socialism and capitalism are plagued by the same sort of decision-making problems, the latter are in a far better position to overcome them by entrepreneurial action. For example, if a large private company runs into trouble managing its divisions, its managers, noticing the inefficiency, can propose a management buyout. Others equally alert can put in a rival tender, and the company can sell as many divisions as it deems judicious. The chances of participants in deals of this kind of making rational decisions are enormously enhanced by prices. They enable everyone to learn of the intentions of the others in the summarized form of money (Hayek 1948, 85) and help them to become alert to discrepancies in intentions (Kirzner 1992, 146). If the planners of a socialist society set about selling production plants they are incapable of managing properly to the high-



est bidders, the means of production would gradually fall into private hands and the society would eventually cease to be socialist.

The failure of the central planners to make the economy work as expected manifests itself in various ways. For example, state enterprises fall short of their production targets due to an inadequate supply of raw materials, so consumers are left without goods they desire despite queuing for hours. In conspicuous cases like this, the discovery of opportunities for mutually profitable exchange requires no extraordinary entrepreneurial skills and tends to make the market forces surface with unusual vigor. Boettke (1993, 65-67) reports that in the former Soviet Union state enterprises in shortage of critical inputs turned to special middlemen for gathering the inputs from enterprises with a surplus and store clerks took bribes while rationing the inadequate supply of goods to consumers.

Planners have an awkward choice when confronted by an emerging black market. They can either prohibit the underground economy and let the disequilibria left by the plan persist, or they can take a permissive stand and thereby admit a loss of the owner's right to decide on the means of production. The latter may be a propitious decision in the short term, but it portends later troubles in the transition to a free market economy. When people have learned under socialism that laws are little more than arbitrary decrees of the government, not meant to be generally enforced, they can have serious difficulties getting used to the idea that universal compliance is a prerequisite for a sustained working of the legal system. Thus, if tax laws are merely regarded as a method to extract money from the taxpayers rather than rules agreed upon to finance public services, and if the decision to comply with the laws is considered a matter of expediency rather than a matter of principled morality, tax evasion prevails and the government fails to perform its duties. In the extreme, a culture of indifference toward the law produces organized crime, originating perhaps in the private enforcement of illicit contracts, which easily eludes the tax authorities and further reinforces the mentality of tax evasion.

The above remarks on the nature of socialism in themselves are enough to indicate that the legal institutions consistent with socialism lack the majority approval of democracy, to say nothing of the unanimous consent of a social contract. The only conceivable way to institute a socialist system is to suppress disagreements by compulsion (Mises 1949, 693). Socialism is a phenomenon of autocracy which serves the purposes of those

holding power and pretends at most in rhetoric to further the welfare of the people (Hayek 1948, 206). Unlike what is taken in a free society for granted, an autocratic government permits its subjects to express their views on common causes and gives heed to public opinion selectively according to its momentary needs. State ownership of mass media, telecommunications infrastructure, universities and other means for disseminating ideas greatly expands the power of the socialist government to control the freedom of speech. Unable to voice their opinions, the people under socialism fail to accumulate the skills of democratic decision-making and find themselves in a strange situation of having to agree on a new constitution and measures to make the transition to a free market economy.

While repeated rituals such as general elections and parliamentary sessions are the most visible aspect of democracy, they catch little of its essence. For most people, majority rule is the most distinctive element of democracy, and may even define the entire political system in some minds. Obviously, laws are enacted by a majority decision in modern democracies, but at a deeper level, the laws must be consistent with higher order principles that practically all members of the *demos* can approve or which express, in the words of Hayek (1968, 88), the “common opinion” of the people. In fact, the most critical phase in democratic decision-making is the stage preceding the formal vote when the people test reform proposals for their consistency with the social contract, seek resolution to emerging disagreements, and frame appropriate compromises. The experiment carried out by Alm, McClelland and Schulze (1999, 160) shows that “cheap talk” among the members of a group prior to a decision is enough to alter the outcome of the game dramatically. Discussions in democracy do not aim at foreknown solutions to conflicts of interests but, as Lavoie (1992, 444) points out, constitute a cumulative process of spontaneous learning that yields novel ideas on the attainment of social peace.

Because members of a socialist society are denied the opportunity to take part in collective decision-making, they fail to acquire the concomitant skills to manage their common affairs. During transition, politics may be therefore viewed, not as a means to discover general rules of law for the benefit of all, but as a relentless fight for privileges like formerly in socialism. When people have learned to look upon each other as rivals for special favors from the government rather than comrades with common goals, they may have difficulties at first in forming themselves into political groups with

coherent agendas. Elster, Offe and Preuss (1998, 249) predict that political parties tend to be organized under such divided circumstances around shared qualities like religion, language and loyalty or opposition to the old regime, which are simple to embrace but of little relevance to the building of the new society. Such futile confrontations tend to further obstruct political decision-making and aggravate the problems of transition. The most favorable conditions for successful social contracting appear to be in small homogeneous societies that have put up a united resistance to the socialist regime.

Finally, relevant to tax compliance in a later transition process, the scanty experience with taxation in socialist regimes deserves mention. A centrally planned economy can dispense completely with taxes if it wishes by manipulating the price structure (Gandhi and Mihaljek 1992, 148). For example, if the government wants the workers to pay more of their product to the financing of public services, it simply lowers wages by decree, thereby increasing the profitability of state enterprises. The additional profits are then credited to the state budget. When the government begins to levy, with the arrival of transition, a direct tax on the incomes of people accustomed to such a system, it may happen that the people believe their tax burden has been raised, they have difficulties in declaring their incomes and, more generally, they are at a loss to understand the new system's motives. Without experience, the government may have trouble finding the most expedient types of taxes, let alone persuade taxpayers to pay them, train the tax officers to make use of advanced audit techniques, and establish a well-organized tax system.

Thus, awareness of the socialist past's influences is necessary for a successful design of tax laws in a transition economy, just like in any other, because of the path-dependence of the evolution of tax compliance. We have seen in this section that the legal institutions and moral climate of socialism provide an exceedingly poor point of departure for the erection of a working tax system. Historical ballast may exert a drag on a former socialist society for decades, maintaining processes of cumulative causation that are hard to break. Johnson, Kaufmann and Shleifer (1997, 167) note that extensive tax evasion early in transition can effect a failure of essential public services, including the maintenance of law and order. This situation, in turn, induces a growing number of taxpayers to move to the unofficial sector, making the government less capable of meeting its duties and giving further cause for evasion. Small events may originally determine which of the multiple paths

is taken, each with its own imaginary end-state or equilibrium. Once members of a society get “locked in” into an adverse path (Setterfield 1997, 59), traveling down a “one-way street” in the words of Hayek (1973, 88), it takes huge efforts to restore the society to a healthier path and bring about a change in the tax-paying climate (Cowell 1990, 114).

We now assemble the lines of reasoning discussed so far and move to an inquiry into practical means to hold tax evasion in check. I have argued that limitations on information and cognition make taxpayers feel to some degree the same obligations to comply with a conceptual tax contract as they feel for contracts of a more ordinary kind. As a consequence of their disposition, taxpayers tend to be more compliant with taxation when they think of themselves as able to give their consent to the tax system. A vital thing for a government to do against this background is to enact tax laws consistent with a conceptual tax contract that members of the society would unanimously vote for if given a chance of expressing their preferences. A mere contract without effective enforcement mechanisms, making those to be bound by it observe its stipulations, is as futile as if no contract were made in the first place. A further task of the government, accordingly, is to make sure that both its own agents and taxpayers have as few opportunities as possible to breach the contract.

The analysis of this section indicates the great problems that the government of a transition economy faces while trying to make people comply with taxation. The suspicions about the legitimacy of political authority, developed under socialism from the arbitrary passing and selective enforcement of laws, may shadow the society far into the future. As a result of the altered nature of the law and suppressed public discussion, people may have genuine difficulties understanding the notion of laws for the benefit of all and the chances of attaining unanimity about their introduction. On the other hand, an improving government reputation and a growing awareness of the rule of law among the people promise to produce drastic increases in compliance, making efforts to bring about changes worthwhile. In the next section we look into how efforts should be directed to obtain the best results.

## 6 Means to increase tax compliance

It is typical of transition economies that, after decades of socialism, the system of taxation must be built from scratch. This puts special demands on the government but presents it, on the other hand, a golden opportunity for taking the findings of economic theory into serious consideration. According to a main argument of my paper, the psychology of the tax contract should play an important role in the economics of tax evasion. The purpose of this section is to examine practical means suggested by this argument to back up tax compliance in transition economies. All recommendations for policy are put forth on the obvious understanding that the government confines itself to using its taxing power strictly within the limits decided by the citizenry.

The simplest way to get a tax law approved by the people is to offer them a general rule that is uncertain in its future impact on individual taxpayers. Such a “veil of uncertainty” as envisioned by Buchanan and Tullock (1962, 78) prevents taxpayers from discerning the effect of applying the rule on their net income, and forces them to consider the rule in a disinterested way or on social grounds. There are several effective ways, hinted at earlier, to make a tax rule appropriate in this specific regard.

First, the rule should determine tax liability in terms of wide classes, rather than concrete specifications, of attributes relevant to taxation. It may be advisable that all income is subject to the same tax and not only wage income or income earned in particular regions or by particular groups of persons. The criterion of unanimity reduces unavoidably the scope for redistribution, but this is the very reason to stick to the contractarian ideal. If the government were at liberty to tax any of its citizens without getting at least tacit prior consent to such taking, little would remind taxpayers of their contractual obligations, so full compliance would hardly be expected. The need to keep away from redistribution is especially pressing in transition economies where citizens, formerly without the protection of a government under the law, go on suspecting the motives of the government and opposing all attempts to interfere with their private property. The average person’s aversion to risk, an essential element in all social contracting (Frank 1993, 271), is probably later directed more toward Rawlsian concerns about distribution, expressed in the famous “difference principle.”

Second, the rule should be applied for a long period of time. This lessens conflicts of interests and, by increasing uncertainty about the effects

on individual taxpayers, dampens the efforts of political pressure groups to tailor the tax system to correspond with their private agendas. Moreover, a government committed to enforcing the new tax rules far into the future also forces itself to draft reforms carefully.

Third, the rule should be applied equally to all members of society, including agents of the government. If the government deviates from uniformity and makes concessions to particular groups of taxpayers, other groups soon seek similar deals and gradually turn the tax system into an unintended patchwork no one will approve (Kornai 1990, 122). The complexity of taxation by itself is enough to cause a mood of hesitancy among taxpayers by making them doubt their skills to notice all the attempts at their exploitation and to take advantage of all the loopholes of the system. Buchanan (1977, 248) remarks that equality does not prevent discrimination in the fiscal system if applied only to the revenues of the state budget and should thus be extended by means of appropriate constitutional devices to the expenditure side.

The tax rules most suitable to all members of society, and therefore most likely to be approved are not ready out there but they have to be discovered. The task of the government is to search for such rules on behalf, or as delegated agents, of the people and then present the discoveries for public discussion and consideration. The agents of the government assigned to legal innovation do their work, like other decision-makers, by following rules with demonstrated superiority. They make use of the experiences, possibly very few, obtained by trying alternative tax rules in the socialist era or even the time preceding it. They model their drafts for reforms on the experiments of other economies in transition. They comb all imaginable sources for crumbs of relevant knowledge.

A further task of the government is to tell people of the necessity to adopt the new rules, explain the general effects of their application, and show that compliance is vital for the society at large. Tax rules that are simple and transparent have the best chances for general approval and assuring future compliance, and thus should be the goal of tax design of transition economies (Pirttilä 1999, 17). Indeed, in its standard recommendations on tax policy, the International Monetary Fund states that in *any* country “overly complicated tax systems tend to generate inefficiencies, inequities, high compliance costs, and tax evasion” (Stotsky 1995, 279).

The government may even go so far in its attempts to make the tax

laws generally accepted as to start educating people on the “constitutional identity” necessary for them to reach a consensus. Taxpayers with such an identity understand that tax laws reflecting general principles are not intended to benefit any particular group at the expense of others, that the laws should be supported or opposed on the basis of their expected overall effects on the society, and that the laws should be complied with even when evasion might be profitable from a purely private point of view.

As a result of learning to consider the interests of the others, the community of taxpayers gradually gains shared views on the acceptability of tax laws. In the end, some laws may stand out as so obvious, or “prominent” in the terminology of Schelling (1960, 57), that they are approved straight away without protest. A simple example of the power of prominence is the decision of a majority of subjects in an experiment, reported by Mehta, Starmer and Sugden (1994, 177), to choose 1, 10 or 100, in lieu of an infinite number of alternatives, when instructed to write down any positive number. Hall and Rabushka (1995, 122) lean on the same notion while proposing in the United States a flat income tax at a uniform rate of 19 percent. They consider less useful for psychological reasons a rate of 20 percent, the double of 10, which would be easier to raise and might thus act as a starting shot for repeated increases in the tax rate. In transition economies, a low round figure would be a clever choice to induce the people first to agree to income tax and, after they get used to the new idea, to make them gradually conform to raising the rate to the level required by legitimate state finances.

The above recommendations for the tax policy of a transition economy are based on the assumption that taxpayers tend to be more compliant with tax laws they are at least in principle able to approve. Besides approved by the parties involved, the terms of the tax contract, like contracts of the familiar type, have to be effectively enforced in order to evoke the rule of compliance. From the point of view of an individual taxpayer, the other parties to the conceptual tax contract are the government and the fellow taxpayers (Pommerehne, Hart and Frey 1994, 56). On that account, the government must have the constitutional requisites for enforcing the tax laws vigorously, regardless of resistance by individual taxpayers. It must have the strength to implement the common will of the people and the integrity to not give in to the greedy intentions of particular interest groups.

Slack enforcement of tax laws in favor of evaders is in the taxpayers’ view unfair, but so is over-enforcement in favor of the government (Cowell

1992, 531). A dilemma of the tax contract is that the government should have enough power to enforce the contract but not too much to misuse the power. I complete this section by listing a few usable means, suggested by Brennan and Buchanan (1980), to set limits on the taxing power of the government, while not curtailing its ability to perform the enforcement function. First, tax laws should be unambiguous so as to reduce the scope for arbitrary interpretation when they are applied. Second, the criteria of taxation should enable taxpayers to perceive their total tax burden and thereby monitor the doings of the government. In this respect, a direct tax such as a personal income tax is preferable to a value-added tax, and a value-added tax is preferable to an inflation tax. Third, the tax base should be less than comprehensive to allow taxpayers some room for protection and keep the appetite of the Leviathan partly in check. Fourth, the taxing power of the government should be decentralized to local levels with unambiguous rules for revenue sharing. The competition of local government jurisdictions for taxpayers is beneficial, besides by confining misuses of the taxing power, by creating conditions for an experimentation with various systems of taxation and a discovery of solutions to tax evasion never occurring to anyone in a centralized system (Vihanto 1992). Both of these considerations have to be weighed against the possible disadvantages of decentralization.

## 7 Conclusions

The government of a transition economy typically needs substantial tax revenues to finance the extensive institutional reforms necessary for establishing a free market economy. Unfortunately, tax evasion tends to be a serious problem in countries making the transition from socialism due to a perverse inherited view of the law and suspicions of government motives generally. The purpose of this paper has been to inquire into a means emanating from the psychology of the social contract to fight tax evasion in such awkward conditions.

Due to limitations on their information and cognition, taxpayers make their decisions to comply with taxation by following rules that have produced good results in the past. The rule of honesty generally has great private advantage in dealings with other people. According to the main thesis of this paper, people will also follow this rule as taxpayers insofar as they see



taxation in conformance with a conceptual social contract to which they give their tacit consent. One means for the government to enhance tax compliance on this view is to enact only tax laws that are in harmony with constitutional rules that meet with the unanimous approval of the people. The expected effects of such a tax policy on tax morale are perhaps nowhere as notable as in transition economies in which the legal system is, as a legacy from the socialist past, unusually far removed from the contractarian ideal. A vital element in the policy is to assure that the tax laws are diligently and consistently enforced so compliant taxpayers do not feel cheated. Tax system designers must also keep in mind that substitution of socially ruinous rules for honesty is difficult to reverse once established, so their introduction must be prevented.

Awareness of the contractarian view is worthless without practical knowledge of the tax rules that the people are likely to agree to at a particular moment in the society in question. The primary means for the government to discover good tax rules is normally to fall back on its own past experience and try to classify it in innovative ways. Since a socialist government dispenses with most of the details essential for taxation in capitalism, a safer approach is to imitate the practices of advanced market economies. However, many of the models working elsewhere are inapplicable to the needs of a former socialist society and, as Gray (1994, 44) gravely warns, may lead to a disaster if aped uncritically without regard for national features. Trial and error experimentation also is available as a method for discovering rules on which to build up a tax system. Whatever approach to developing the social contract the government of a transition economy chooses to take, it must be prepared for unexpected changes in public opinion brought about in the course of the spontaneous learning of social contracting.

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