How Should We Think About Wealth Tax Avoidance?

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Diana Onu, Lynne Oats, Erich Kirchler, & Andre Julian Hartmann, *Gaming the System: An Investigation of Small Business Owners' Attitudes to Tax Avoidance, Tax Planning, and Tax Evasion*, 10 **Games** 46 (2019).

A recently published empirical study by Diana Onu, Lynne Oats, Erich Kirchler, and Andre Julian Hartmann compares taxpayer attitudes towards acceptable tax planning, aggressive (yet legal) tax avoidance, and illegal tax evasion. While the study itself examines small business owners subject to income tax in the U.K., its implications should be of great interest to policymakers concerned about legal avoidance strategies with respect to any tax base. For example, aggressive but legal tax avoidance might be an important concern under recent wealth tax proposals in the United States.

As noted by the study's authors, tax compliance literature has traditionally focused on the binary choice between compliance and evasion. That literature explores the various underpinnings of the decision to evade, from deterrence theory, to social norms, to attitudes that evasion is a victimless crime. But largely absent from this literature on individual taxpayers are studies of the motivations underlying aggressive, yet legal, tax avoidance strategies. In thinking about the U.S. tax system, this makes sense. Aggressive avoidance strategies are typically attributed to firms, where individual attitudes and other psychological factors are arguably less relevant. Evasion, on the other hand, is typically attributed to individual taxpayers (most often, sole proprietors), who often lack the resources to employ aggressive yet legal avoidance strategies. But if the U.S. were to adopt a wealth tax like the one proposed by Elizabeth Warren, the stakes or potential payoffs from avoidance might grow. If so, individual level avoidance strategies would presumably become much more commonplace.

So what do we know about the psychological factors that motivate legal tax avoidance, as distinct from evasion? It turns out, not much, but the study by Onu, Oats, Kirchler, and Hartmann sheds some light on this question.

In the study, 330 small business owners in the U.K. were surveyed using a 7-point Likert scale to gauge how they would respond to hypothetical scenarios involving tax minimization strategies. For example, participants were asked how likely they would be to participate in a tax scheme that uses an offshore intermediary if an accountant endorsed it as a legal method to generate significant tax savings. The responses reveal that participants differentiate three types of behavior ranging from least compliant to most compliant. The behavior types include what the authors describe as: (1) "tax planning" (saving tax in a manner intended by the law); (2) "tax avoidance" (complying with the letter of the law but not its spirit, solely for the purpose of saving tax); and (3) "tax evasion" (illegal practices like concealing income).

The study also surveyed participants on various attitudes towards taxes, including personal norms, social norms, fairness, perceptions of audits and penalties, knowledge of the tax system, and the seriousness of evasion. This allowed the authors to use a linear regression analysis to link particular attitudes to tax planning, tax avoidance, and evasion.

The study revealed some interesting distinctions. The likelihood of engaging in tax planning was linked to “the belief that the tax system is flexible and …[may] be used for tax efficiencies,” as well as having high levels of confidence in one’s knowledge about taxes.

The likelihood of engaging in tax avoidance was similarly associated with a belief that the tax system is flexible. However, tax avoidance was also linked to beliefs that the tax system is unfair and that it can be exploited for profit, and to “low personal norms of public good contribution” (i.e., low tax morale).

Tax evasion was not associated with beliefs about the tax system at all. Rather, people who indicated willingness to engage in tax evasion were those who did not perceive tax evasion to be a serious crime, and who had low tax morale.

In sum, both tax avoidance and tax evasion are associated with low tax morale but tax planning is not. Importantly, the predictors of tax avoidance and tax evasion also differ. While avoidance is associated with a belief that one is treated unfairly by the tax system, evasion is associated with a view that it’s a trivial crime.

These findings have enormous implications for tax compliance scholars and policymakers. If we extend the traditional focus of the tax compliance literature beyond evasion to include legal avoidance strategies, the importance of taxpayer *beliefs* becomes much more important. While perceptions of fairness, for example, appear to be relatively unimportant to the decision to over-claim business deductions (evasion), they appear to be highly relevant to the decision to adopt legal yet aggressive avoidance strategies like moving assets offshore.

This brings us back to wealth taxes. As many commentators have pointed out, a major downside of a wealth tax is the administrative cost and efficiency loss resulting from sophisticated and highly resourced individuals attempting to avoid it. Although not aimed at wealth tax compliance, the study by Onu, Oats, Kirchler, and Hartmann sheds some light on the factors that would predict such avoidance. If we think perceptions of unfairness or other negative beliefs are particularly high in the U.S., we have reason to think wealth tax avoidance may be more prevalent than income tax evasion.

Perhaps most illuminating about linking tax avoidance to taxpayer attitudes is the following point made by the authors: “Of course, capturing what is moral at any given time is difficult….[T]he definition of what is acceptable practice is socially-situated and will shift in different historical periods or social groups.” In other words, attitudes about what constitutes unacceptable tax avoidance versus appropriate tax planning are context-specific and likely to shift over time. This point is highly relevant to the current debate over wealth taxation in the U.S. Some commentators have argued that wealth taxes are feasible because, in the past century, the U.S. has taxed rich people at much higher rates than it does now, which shows that collecting more taxes from the rich is possible (i.e., won’t necessarily trigger total avoidance). While this point has merit, there is also reason to be cautious about whether our historical experience can be relied upon.

It may be that the high marginal rates throughout much of the 20th century were possible because beliefs about the tax system were much different than they are today. For example, if today’s taxpayers have low tax morale and perceive that they are being treated unfairly by the tax system, we may in fact see more legal avoidance than in years past. The study by Onu, Oats, Kirchler, and Hartmann suggests that taxpayer beliefs may be one of the most important drivers of avoidance behavior. Policymakers would be well advised, therefore, to take such beliefs into account in designing taxes and take steps to combat low tax morale and perceptions of unfairness.

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