

# **THE IMPORTANCE OF BEHAVIORAL ECONOMICS IN TAX RESEARCH AND TAX REFORM: THE ISSUES OF TAX COMPLIANCE AND TAX SIMPLIFICATION.**

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## **Abstract**

This paper presents evidence that too narrow an approach in research can produce misleading conclusions when the wider context of the tax system and the environment in which it has to operate are considered. Two areas are used to illustrate this situation – tax compliance and tax simplification. A behavioral factor – the ability and willingness to consider a complex and changing wider environment - might not only be one explanation for the narrowness of much research but also why tax reform itself is often conducted on an incremental and *ad hoc* basis. This paper therefore goes on to develop a systematic or strategic approach to tax reform and suggests a role for a permanent body to oversee the process – similar in some ways to the role reserve banks play in the conduct of monetary policy.

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## 1. Introduction

It is not difficult to find an appreciation of the importance of behavioral issues in taxation stretching back to the English classical economists such as Smith, Ricardo and Mill. However, as Section 2 goes on to indicate, economics later tended to follow a narrower approach – a situation that often continues to the present time. Nevertheless, economic analysis itself makes it clear that applying analysis to important policy issues is a very complex process, and two particularly relevant areas – the general theory of the second best and optimal tax theory, are also discussed in Section 2.

Examples from two particular areas – tax compliance and tax simplification – are used to illustrate how too narrow an approach can limit the usefulness of otherwise relevant research. For instance, some research on tax compliance seems to assume that compliance is the most important aspect of a tax system and the tax system should be designed to minimize compliance costs. Similarly some research on tax simplification over emphasizes the importance of simplification and neglects the possibility that other aims and realities of the tax system and may have a higher priority.

An approach that takes a wider behavioral perspective – including the range of government policies which are sometimes at least partly implemented through the tax system – may result in conclusions that can be quite different from those generated by a narrow research approach. For instance, tax compliance is often discussed in terms of minimizing compliance costs. However if, for example, the purpose of a particular tax is to discourage certain behavior such as the use of alcohol or tobacco or even possibly the consumption of fatty foods on health grounds (O’Donoghue and Rabin, 2006), then the conclusion may no longer be that compliance costs should be minimized – indeed higher compliance costs might help achieve the objective. This sort of possibility is discussed in relation to tax compliance in Section 3 and tax simplification in Section 4.

This leads onto the question of how tax research can be incorporated into a wider analysis of the issues involved in improving the tax system. Therefore, Section 5 turns to tax reform in the light of such considerations including behavioral aspects. Human limitations in terms of knowledge and understanding in an uncertain world might mean that the most rational approach to tax reform is an incremental one – considering one part of the whole only at a time. Indeed much economic analysis proceeds on the basis of holding everything constant except that which is the focus of study. That is a perfectly acceptable way to proceed but there should also be a process for including wider considerations to complete the analysis. Hence this paper develops a wider or more strategic approach to these matters and indicates the advantages this might have for tax reform in the longer term. The main themes of this paper are the necessity of following a wider approach in applying tax research and reforming taxation successfully and also the importance of mechanisms to ensure that tax systems continue to achieve their intended purposes in changing circumstances.

## 2. Economics and Behavioral Economics

Taxation has been the object of study by the English classical economists such as Adam Smith. Many of them took account of behavioral factors as a matter of course. Indeed Adam Smith's 'four maxims' regarding taxation in general have become the starting point for many subsequent contributions over the years and each of them has a behavioral dimension. The first two maxims relate to his view of the fairness of taxes and that taxes should be certain, not arbitrary. The third is that every tax 'ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it'. Finally taxes 'ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state' (Smith, 1776, bk. V, ch. II, pt. II). Smith also indicates some of the psychological costs of taxation. In a memorable passage he says that 'the odious examination of the tax gatherers' may cause taxpayers 'much unnecessary trouble, vexation and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it.' (Smith, *ibid.*)

David Ricardo devoted ten chapters of his *Principles* to problems of taxation and was also well aware of the importance of behavioral factors. For example he stated that taxation, whether it was levied on capital or on income, would be paid from income because of the 'desire which every man has to keep his station in life, and to maintain his wealth at the height which it has once attained' (Ricardo, 1821, ch. VIII). As a further illustration, in his famous comparison between direct and indirect taxation, John Stuart Mill stated that in England there had long been a popular feeling opposed to direct taxation such as income tax. He went on to say that this feeling 'is not grounded on the merits of the case, and is of a puerile kind. An Englishman dislikes, not so much the payment, as the act of paying. He dislikes seeing the face of the tax-collector, and being subject to his peremptory demand.' Mill went on to suggest that if the level of taxation remained the same but indirect taxes were incorporated into direct taxation 'an extreme dissatisfaction would certainly arise...while men's minds are so little guided by reason' (Mill, 1848, bk. 5, ch. 6).

As Economics came to replace the old discipline of Political Economy in the twentieth century such wider aspects of behavior were not usually included in more 'scientific' economic analysis of taxation. Neoclassical economics became more focused than the classical economists had been and there seemed to be less concern with why individuals behaved the way they did, simply that they had acted on rational economic and self-interested criterion narrowly defined.

There are many formulations of neoclassical theory. For example, Edgeworth was quite clear that 'Economics investigates the arrangements between agents each tending to his own maximum utility' (Edgeworth, 1881, p. 6). Furthermore the 'first principle of Economics is that every agent is actuated only by self-interest' (p. 16). We are indebted to Jevons (1871) for the narrow concept of economic behaviour as a 'calculus of pleasure

and pain' but even he remarked that the 'fearless manner in which Mr Edgeworth applies the conceptions and methods of mathematical physics to illustrate, if not solve, the problems of hedonic science, is quite surprising' (Jevons, 1881, p. 581). Edgeworth went on to apply his approach to taxation, stating for example that the 'science of taxation comprises two main subjects to which the character of pure theory may be ascribed; the laws of incidence and the principles of equal sacrifice' (Edgeworth, 1925, p. 64).

The narrow approach to the analysis of human behaviour on the basis only of immediate self interest narrowly defined has always attracted powerful criticism. For example Veblen (1898) was very scathing in his description of the hedonistic conception of man. According to Veblen, this conception envisaged an individual as a 'lightning calculator of pleasure and pains, unaffected by experience with neither antecedent nor consequent, in other words a purely passive, isolated and 'self-contained globule of desire.' The arguments have been repeated and developed ever since. Although there seem to be two separate approaches, mainstream and behavioral economics, they are in many ways two contributions to the same study. Edwin Cannan (1946, p. 4) put it well in writing that there 'is no precise line between economic and non-economic satisfactions, and therefore the province of economics cannot be marked out by a row of posts or a fence like political territory or a landed property.'

More recently, two particular areas that have produced important insights into the complexities involved in applied economic research are the general theory of the second best and optimal taxation. Public choice theory also has much to offer but the implications of that analysis will be left to a later paper.

### *The General Theory of the Second Best*

One of the themes in this wider approach to compliance and simplification is the interdependence between different economic, as well as political and social, variables and realities. The theory of the second best states that it 'is *not* true that a situation in which more, but not all, of the optimum conditions are fulfilled is necessarily, or is even likely to be, superior to a situation in which fewer are fulfilled' (Lipsey and Lancaster, 1956, p. 12). Indeed the general theory of the second best holds that if one of the Paretian optima cannot be achieved then a second best optimum can be reached by departing from all the other optimum conditions. Furthermore, nothing can be said in general about the direction or the magnitude of the secondary deviations from optimum conditions made necessary by the inability to achieve the original optimum condition. Lipsey and Lancaster actually illustrate this with a tax example. They suppose that a tax is imposed on one good only and the revenue raised is returned as a gift to the purchasers so the only result is to distort relative prices. Given this distortion, the only general thing that can be said is that a second best optimum could only be achieved by a system of taxes on other goods and services, some of which may be more than, some less than, the original tax and in some cases a subsidy might be required.

Furthermore, the tax system is not an independent entity and imperfections in the tax system may have implications for the pattern of public expenditure. For example, Balestrino and Galmarini (2003) argued that imperfect income tax compliance implies it is desirable that the supply of public goods should be distorted downwards. At a more detailed level an infinite amount of such analysis is possible. For example, West and Williams (2007) estimate the parameters required to calculate the optimal second-best gasoline tax.

The general theory of the second best is not good news for those happy with just a narrow view of economics, taxation and tax reform. Incorporating a wider analysis into tax reform is naturally much more complex than following a simplistic approach and Harry Johnson (1970) added his own particular view:

The fundamental problem is that, as with all second-best arguments, determination of the conditions under which a second-best policy actually leads to an improvement of social welfare requires detailed theoretical and empirical investigation by a first-best economist. Unfortunately, policy is generally formulated by fourth-best economists and administered by third-best economists; it is therefore very unlikely that a second-best welfare optimum will result from policies based on second-best arguments (Johnson, 1970).

Such levity aside, the implication of second best analysis is that the failure to consider a much wider range of factors than is currently the norm might mean that an 'improvement' in tax compliance or simplification does not lead to an overall improvement at all. When the wider context is included, the overall disadvantages may be greater than the more obvious benefits of the initial change.

The literature on optimal taxation adds further insights and is therefore also described briefly.

### *Optimal Taxation*

The work on optimal taxation is relevant because the literature is concerned with tax structures that take account of both the requirements of economic efficiency and the need to be fair between one taxpayer and another. It is concerned with questions such as whether income or commodity taxes should be used and how should tax rates vary across commodities. The equity dimension relates to the question of how progressive the tax system should be. To some extent, of course, there is a trade-off between the two criteria of efficiency and equity. A tax system that is economically efficient may not be considered fair and vice versa and the purpose of much of the optimal taxation literature is to find the best balance between the two. Having said that, it is not always easy to model what is considered to be fair and there have been difficulties in incorporating important variables.

One of the earliest and most famous contributions was Ramsey's (1927) which concluded that uniform commodity taxes were rarely optimal, though it might be noted that the analysis abstracted from the costs of operating different tax rates. There is now a

considerable literature on optimal taxation though Broome's (1975) parody suggests that it should not always be taken literally. Frey (1976, p. 32) pointed out that optimal taxation will only be introduced if it is acceptable within the political-economic process. Feldstein (1977) criticized the literature for concentrating too much on the features of the optimum and too little on the process of attaining it. An accessible summary is provided by Heady (1993) who also raised the specific question of the contribution optimal taxation could make to practical tax policy. Although that literature clearly offers some important insights, it cannot help in all areas of tax policy.

Indeed the difficulty of applying much of the work in optimal taxation to policy issues is a constant theme. Alm (1996) suggested that previous attempts to derive an 'optimal tax system' were largely irrelevant to practical tax design since they ignored a range of considerations involving fiscal and social institutions. He argued that many of the relevant institutional features could be included in an optimal tax framework but acknowledged that it would never be able to incorporate all of the 'incredible complexity' that must be considered in the design and reform of tax systems.

Nevertheless optimal taxation continues to develop and often in the right direction, for instance Gradstein (1999) examined political mechanisms that ensure efficiency enhancing restraints on taxation. In the context of the present paper, the discussion of optimal taxation and evasion is particularly relevant. As with other areas the analysis results in important insights but not to precise policy prescriptions. Cremer and Gahvari (1994) suggest that the optimum marginal tax rate is lower in the presence of tax evasion but this depends on their particular assumptions. An increase in tax rates may improve economic efficiency as it might cause some labour to move into the illegal labour market which may be less economically distorted than the legitimate one. However, as Sandmo (2005, p. 658) points out, there are some serious implications in viewing 'anti-social behaviour' as a social gain in this way. There is the theoretical but rather crude insight that the probability of detection in the form of an increased frequency of audits and penalties for evasion are substitutes. Concern in minimizing compliance costs might indicate a preference for the latter. However, on equity grounds, if no other, that approach may lead to unacceptably high penalties for the few who are caught for crimes committed by many individuals who escape unscathed. In any case the decision to evade may well be heavily influenced by behavioural rather than economic factors narrowly defined (James *et al.*, 2001).

The recent study by O'Donoghue and Rabin (2006) used the optimal taxation framework to examine 'sin taxes' – such as those on unhealthy foods that people might consume more than they should because they lack self-control or some other problem. The existence of merit goods or merit bads where the government and individuals have different ideas of the individual's optimal consumption was raised by Musgrave (1959) and discussed ever since. In a sense an individual's consumption that does not take full account of future harm might be thought of as an internal externality with respect to that individual's future health – or an 'internality' as Hernstein *et al.* (1993) put it. O'Donoghue and Rabin show that introducing taxes on unhealthy items and returning the proceeds to the taxpayers can increase economic welfare, but such a conclusion can be

reached without using optimal taxation analysis. The authors also acknowledge that the analysis has numerous limitations. This is generally in line with the nature of the optimal taxation approach and so the policy implications are also limited.

However, the optimal taxation approach once again makes it clear that to develop changes to the tax system where the overall advantages definitely outweigh the disadvantages is a difficult and complex process. Yet it is also clear that giving the wider context less attention than it deserves is not the way to proceed.

### **3. Compliance**

On the basis of a thorough analysis of the extensive research into tax compliance in Australia, Turner (1996, p. 5) found:

The tendency has been to define the scope of study too narrowly with the result that researchers have lost sight of the fact that this is merely one small facet of the citizen's relationship with the state.

And:

The view that incremental costs of complying with the tax laws can be studied without reference to the total system costs is unnecessarily narrow and unlikely to help in understanding the subject. There has been an excessive emphasis on exploratory research.

There is also evidence of similar limitations to tax compliance research in other countries. There is a huge body of research on tax compliance (see for example, Fischer, *et al.* 1992, Richardson and Sawyer, 2001 and Ahmed, *et al.* 2003) and, in particular, there has been a constant stream of studies estimating actual compliance costs but without considering compliance costs as part of wider tax policy. For instance such studies often imply that all would be well if only compliance costs were low and progressive rather than high and regressive. As indicated above, whether this is correct or not depends on a range of factors and if a tax is being used to discourage a particular form of behaviour then higher rather than lower compliance costs might even be desirable. As an example with respect to the issue of progressivity, it does not follow that each part of the tax system has to be equally progressive, or indeed even that every part of it individually has to be progressive at all. It certainly does not require that compliance costs always have to be progressive.

It may be, of course, that some research is deliberately focused only on a small aspect – such as a particular estimate of compliance costs in a specific context to be concerned about such wider issues. An example is the study by Shekidele (2001) of excise duties in Tanzania. However, that study includes some discussion of the background and could have linked compliance cost issues with other considerations. Sometimes researchers are aware of trade-offs between different parts of the tax system but do not seem to follow this through in full. For example, Serra (2003, p. 374) states that the goal of the tax administration should be to minimize collection costs for a given tax structure and tax

administration budget and that joint minimization of tax evasion and costs of compliance can be used as a proxy for minimizing collection costs which would be very difficult to observe directly. He argues that the compliance rate could serve as the effectiveness indicator for the compliance maximization objective (p. 374). Serra's argument for maximizing tax compliance is that minimizing tax collection costs should be a goal of the tax administration and that tax collection costs generally fall when there is a higher rate of compliance (p. 375). He is aware of the trade-offs of different aspects of the tax system going on to say that higher compliance means the government could have either lower tax rates or administrative costs and the optimum response is likely to be a combination of the two. He adds that the precise relationship between compliance and collection costs depends on the way compliance maximization is achieved (p. 376). It is also acknowledged in the conclusion that the compliance rate is not appropriate as an indicator of the effectiveness of tax administration since tax compliance is influenced by factors other than the tax administration – such as high economic growth – and because tax enforcement could increase compliance costs. Serra therefore concludes that a second objective for the tax administration should be 'to minimize compliance costs'.

### *The Development of Behavioral Models*

One area that has developed considerably is a more behavioural approach to tax compliance. This has a great deal to offer in terms of supplementing and extending mainstream economic analysis. It may be that there are better ways of achieving compliance than the narrow economic one of concentrating on the frequency and level of auditing and penalties for those caught misbehaving. Taking account of such factors might not only enable improvements to be made in compliance policy but also to improve co-ordination with other government aims, objects and public expenditure programmes.

There are many contributions from different disciplines that suggest there is a range of other factors that might influence taxpayers' behaviour. For instance, work in sociology has identified a number of relevant variables such as social support, social influence, attitudes and certain background factors such as age, gender, race and culture. Psychology reinforces this approach and has even created its own branch of 'fiscal psychology' (Schmölders, 1959, Lewis, 1982). The contribution of psychology includes the finding that attitudes towards the State and revenue authorities are important factors as well as perceptions of equity in determining compliance decisions. Economic psychology also stresses the importance of attitudes, morals, values, and fiscal consciousness (Cullis and Lewis, 1997). The roles of individuals in society and accepted norms of behaviour have also been shown to have a strong influence (Wenzel, 2001a and 2001b). Braithwaite *et al.* (2003) examined such factors as the perception of justice and how social norms and laws can undermine each other.

The main theme of this approach is that individuals are not simply independent selfish utility maximisers (though this might be partly true) but that they also interact with other human beings in ways which depend on different attitudes, beliefs, norms and rules. It also means that taxpayers can be expected to act as responsible citizens. That is, in



normal circumstances, they should conform to reasonable obligations of the tax system without the extensive application of enforcement activity.

There are many detailed contributions to this approach - including some by economists. For example, Spicer and Lundstedt (1976) examined taxpayer norms and attitudes towards the tax system and tax offenders and Spicer (1986) non-maximising behaviour more recently. The importance of equity and fairness has also been a frequent theme (for example, Bordignon, 1993 and Cowell, 1992). Background factors such as cultural influence have been examined (Coleman and Freeman, 1997), so too have the implications of different political systems (Pommerehne *et al.*, 1994). More direct contributions to policy in this area have come from a number of authors. For example, one is an appeal to taxpayers' conscience (Hasseldine and Kaplan, 1992) and also to feelings of guilt and shame (Erard and Feinstein, 1994). It is also possible that taxpayers consider the benefits the community receives from government expenditures (Falkinger, 1988). There may therefore be scope to improve compliance by drawing attention to the benefits of public spending. Many more papers could have been cited but this section has attempted to give an indication of the range of academic evidence that supports the behavioral approach.

What is still needed, however, is to link all this with wider considerations concerning the tax system as a whole. A similar conclusion can also be made with respect to tax simplification.

## 4. Tax Simplification

An early paper entitled 'Tax Simplification' in the *Accounting Review* ended: 'The results will largely be measured by the number of pages remaining in the Code' (Bachrach, 1945, p. 103). That would certainly be a simple measure of tax reform with respect to tax simplification but probably not the most useful and certainly not a good measure of improvement of the tax system as a whole.

In the area of tax simplification there have been authors who have recognised that other factors might also be important. For example, Kaplow (1996) described a relatively simple framework which incorporated equity and efficiency matters with complexity and compliance. However, there has also been a tendency in the areas of tax simplification to overestimate the importance of just one aspect and the most vivid example is the view that the solution to the problem of complexity in the tax system is largely a matter of simplifying tax law.

### *Tax Law Reviews*

In both Australia and the UK a response to these issues has been tax law review projects. In the UK the Tax Law Review Committee was set up in 1994 to rewrite tax legislation in plain English and examine explanatory documentation. In Australia the process began with a report produced by the Joint Committee of Public Accounts in 1993 and the Tax Law Improvement Project (TLIP) was set up with the task of improving the 'understanding of the law, its expression and its readability' (Tax Law Review Team, 1994). There is no doubt that improvements have been made, though such attempts have not always been well received. For example, in Australia Lehmann (1995) referred to some of the rewritten law as 'kindergarten babble' and cited 'Your assessable income includes income according to ordinary concepts, which is called ordinary income'.

There does seem to have been a view at the time that the tax law rewrites were the solution to the problem of excessive complexity but, certainly on their own, they are not. An initial part of the Australian rewrite duly appeared as the *Income Tax Act 1997*. In reviewing the position, Krever (2003) pointed out that a superficial look at that Act seemed to support the view that the complexity of the system was the fault of the drafters of earlier legislation. However, he went on to say that taxpayers and their advisers soon discovered that, although the new legislation was easier to read and comprehend than what had gone before, the complexity was still there. In fact the process had exposed the true cause of the previous law's complexity – that is its 'wholly irrational and inconsistent policy base' (p. 493). Furthermore, TLIP seemed to have distracted attention from the normal process of revising tax legislation outside the project where problems continued and might even have increased. In the UK the Tax Law Review Committee's final report (1996) listed three types of complexity – linguistic, policy and compliance – and acknowledged that a comprehensive tax reform would have to address all three areas (paragraph 6.10). The Committee also stated that 'without policy changes the benefits from rewriting legislation are limited' (paragraph 12).

A recent Australian contribution has been the Taylor Report (2006) on reducing tax law complexity. The principal conclusion was that the fundamental principles the tax law was trying to express were obscured by excessively detailed operational rules and the report made a number of recommendations for improvement.

Although initiatives such as tax law improvement are to be welcomed, in both Australia and the UK they have been limited in that they were concerned with only part of the problem, complexity of language, and sometimes that is only a small part of the problem. These initiatives made no serious attempt to address the underlying complexity of the tax system and the process of tax reform generally from which such complexity arises (James and Edwards, 2007). Nor was there much recognition that other aims and realities of the tax system might sometimes be more important than simplification. As in the case of compliance, what is needed is a much wider approach to these issues. Just as an indication of the complexity of simplicity, even the concept is difficult, as outlined by Cooper (1993) who suggests there are at least 7 issues:

1. Predictability – in this context, a rule would be simple if that rule and its scope were easily and accurately understood by taxpayers and their advisers.
2. Proportionality. A rule would be simple if the complexity of the solution were no more than reasonably necessary to achieve the intended aim.
3. Consistency. This would apply where a rule deals with similar issues in the same way and without the need to make arbitrary distinctions.
4. Compliance. A rule would be simple if it were easy for taxpayers to comply without incurring excessive costs.
5. Administration. A rule would be simple if it were easy for a revenue authority to administer.
6. Co-ordination. A rule would be simple if it fitted appropriately with other tax rules; it would be complicated if its relationships with other rules were obscure.
7. Expression. A rule would be simple if it were clearly expressed.

Cooper also suggested that simplification could be seen as being at different levels. The first level is the choice of the tax base, whatever that may be. The second is the design of the rules to be applied to the tax base. The third is in the expression of those rules and the final level of complexity is the administrative requirements imposed on taxpayers.

With tax simplification, as well as compliance, a complex approach is needed to deal with a complex problem.

## 5. Tax Reform in a Behavioral World

All the different factors relating to taxation mean that it is very difficult to develop and implement tax reform successfully. William E. Simon, a former Secretary to the US Treasury commented that the 'nation should have a tax system which looks like someone designed it on purpose' (US Treasury, 1977). The President's Advisory Panel on Federal Income Tax Reform (2005, p. 1) stated that: 'If you were to start from scratch, the current tax code would provide a guide on what to avoid in designing an income tax system'. The Panel went on to say that instead of clarity there was opacity, instead of simplicity there was complexity, instead of fair principles there appeared to be arbitrary rules, instead of promoting economic growth it was an obstacle to growth. Similar comments have been made about other tax systems. For example, recently in the UK the Tax Reform Commission (2006) found that the UK tax system was too complex, too unfair, too unstable and undermined economic growth.

With many different and changing demands and constraints on tax systems, perhaps it is not surprising tax systems turn out as they do. Successful tax reform can be a surprisingly complex process even if there appears to be only a simple objective. Bird and Oldman (1990, p. 3) have suggested that the best approach to tax reform is one that takes:

into account taxation theory, empirical evidence, and political and administrative realities and blends them with a good dose of local knowledge and a sound appraisal of the current macroeconomic and international situation to produce a feasible set of proposals sufficiently attractive to be implemented and sufficiently robust to withstand changing times, within reason, and still produce beneficial results.

They say that this is often beyond reach as a result of deficiencies all round, though progress has been made. Nevertheless it is clear that tax researchers who claim their results will improve the tax system should be taking account of a wide range of factors.

It is certainly true that tax reform is often made on an *ad hoc* basis and is not always successful. Different models of policymaking with respect to tax often capture part of the reality but not always the full nature of the process - especially when there are radical changes. Briefly, pluralist theory suggests policy outcomes are the result of inputs from numerous special interest groups where bargaining between them takes place through the political process (Dahl, 1982). It is quite possible that the most powerful interest groups may achieve a result in their favour at the expense of influential groups though the reality seems to be more complex - with different forces having more or less success at different times. Within a pluralist framework, income tax can be seen to have developed usually as a result of limited decisions made incrementally over time. Such an evolutionary or incrementalist model certainly describes how much of the tax policymaking process occurs. However, the various models do not provide a complete explanation particularly with regard to fundamental tax change. For instance, even Witte (1985), who strongly argues the case for incrementalism as an explanation for change in income tax, provides clear evidence that fundamental changes occur as a result of war or fiscal crisis. This is reinforced by Brownlee's (1996) historical account of federal taxation in the US where he

describes clearly how new tax regimes emerged from the national crises of the Civil War, the First World War, the Great Depression and the Second World War.

As a more recent example, it has been argued (Conlon *et al.*, 1990) that the US Tax Reform Act of 1986 (TRA86) did not conform to the conventional pluralist/incrementalist model. The aims of the reform as stated by Aaron (1987) were to produce a tax system that was 'more conducive to economic efficiency and growth, fairer and simpler'. The Act abolished or restricted many tax concessions, reduced tax rates and removed many poorer individuals from federal income tax altogether. The process leading to this reform had managed to survive many of the demands of special interest groups. Indeed Slemrod and Bakija (1996, p. 6) commented that the 'tax shelter industry was devastated' – the value of tax concessions fell by an estimated \$200 billion so that despite the lower rates roughly the same revenue continued to be raised. TRA86 seemed to come about as a result of several factors. Economic and fiscal conditions were favourable (Steuerle, 1992), and the political context was just right (Leonard, 1996). The personalities and leadership qualities of those with major roles were very important (Birnbaum and Murray, 1987) as was the support of the media, the way the proposal was developed and so, it has to be said, was chance.

The evidence from a collection of essays on TRA86 edited by Slemrod (1990) seems to suggest that the economic responses were generally less than expected. However, given the complexity of modern economies it is perhaps not surprising that there is not a great deal of hard economic evidence that TRA86 was a success but after a comprehensive analysis of that evidence Auerbach and Slemrod (1997) concluded that it was. It is not possible to know how the tax system would have developed without TRA86 which might, at the very least, have prevented the situation from becoming worse.

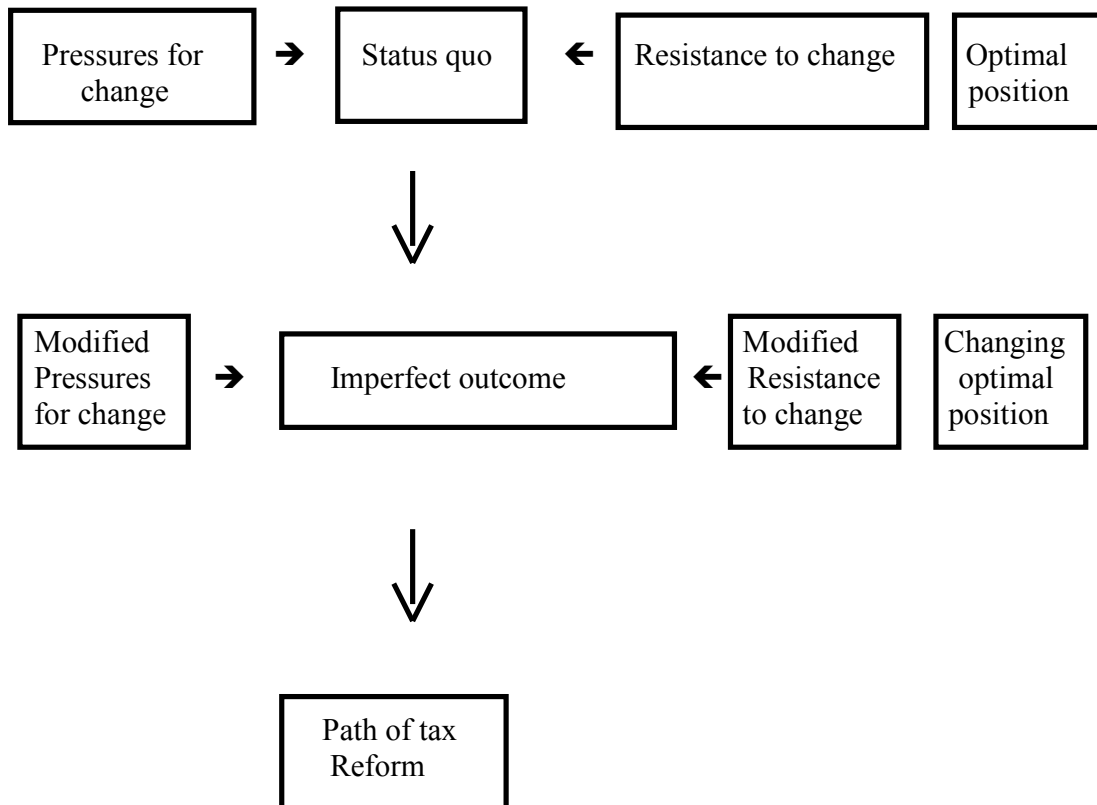
Given the inherent complexity of tax policy and its effects, it could be argued that incrementalism might offer a rational response to an uncertain world – small steps might not achieve all the aims of the tax system in full at once but they might also avoid large and unexpected adverse results that might be associated with more radical changes. Hence incrementalism might offer a strategy for the best approach to tax policymaking. A fully comprehensive-rational model of decision-making involves limited human reasoning, and knowledge, difficulties in forecasting future trends and events, time limitations, the uncertainty of the outcome of political disputes and campaigns - all of which hamper the full evaluation of all alternatives. As Pollack (1996, p. 254) put it, incrementalism is therefore 'a strategy for a process of limited, gradual tax policymaking.'

There has, of course, been a long standing academic debate about such issues. In the 1950s the 'rational-comprehensive method' hoped to use rational/technical approaches such as game theory to understand the political process. However, Lindblom (1959) in his classic paper 'The Science of Muddling Through' saw the policy process as a much more limited exercise which would be repeated endlessly as aspirations and conditions changed. In refining this model into 'the strategy of disjointed incrementalism' Braybrooke and Lindblom (1963) had no difficulty in demonstrating that full

comprehensiveness is impossible in most policy decisions though Lindblom's view that the solution lies at the other extreme from that approach – small steps rather than major decisions - may not always be right either. However the incrementalist approach clearly has merit and has also been followed in related areas such as budgeting incrementalism by (Hecl and Wildavsky, 1981). It also has features in common with work in economics by Herbert Simon (1982) on bounded rationality, satisficing and the principle of continuity of approximation (see, for example, Fels, 1981).

What is clear is that tax reform is a dynamic process – a continual process of adapting tax systems to changes in emphasis of aims and objectives and constant changes in the economic and social environment. Of course, there is a great deal of inertia. A way of modelling the dynamic process of tax reform, including the existence of inertia, is the use of forcefield analysis developed from the work of Lewin (1951). This approach acknowledges the complex array of different interests and factors involved in the way tax systems develop and the nature of the political process itself. Forcefield analysis reflects the reality that at any time there will be all sorts of different pressures for change developing, and there will also be a variety of developing forms of resistance to change as illustrated in Figure 1.

**Figure 1 A Forcefield Approach to the Process of Tax Reform**



The optimal outcome might be identified perhaps, as in this illustration, somewhere behind the resistance to change. Eventually the pressure for change might overcome the resisting forces, but the latter remain strong enough to deflect change from the optimal position and the result is an unsatisfactory compromise. This, of course, is only part of the continuous process of change so, as also indicated in Figure 1, the pressure and resistance to change as well as the optimal position also continue to develop (James, 1999).

So, some systematic method of coping with the complexities of such a process is required.

## 6. Developing a more Strategic Approach to Tax Reform

One way forward seems to be to incorporate a wider approach to such issues by developing a strategy for improvements and earlier attempts have been made in the case of compliance (James, 2005) and simplification (James and Wallschutzky, 1997). In both cases the emphasis was that the approach should not be on an *ad hoc* basis but in the form of a strategy that takes account of the different factors involved and the best ways of responding over time to particular issues in the context of the tax system as a whole. Such an approach might also improve the applicability of tax research more generally.

The academic discipline that has paid most attention to the subject of developing strategy is Management. An essential input in the development of successful strategies is the systematic analysis and understanding of the factors involved. This includes the wider environment in which the activity is being conducted as well as the areas of immediate concern. A key part in the development of strategy is implementation. Henry Mintzberg (2004) is one of the most prominent management scholars in the area and believes that strategy is an interactive process requiring constant feedback between thought and action and that successful strategies evolve from experience. He also stresses the importance of strategists having expertise in the area. Other commentators such as Grant (2002) are also clear that the formulation and implementation of strategy go together. A well-designed strategy should take account of the process of implementation and it is through the implementation that a strategy can be refined and reformulated.

There are certain distinct stages in developing such a strategic approach and one possible ten stage plan consists of:

1. Identify the aims of taxation
2. Establish different methods of achieving the aims
3. Analyse in terms of the economic criteria.
4. Specify the administrative constraints
5. Identify different risks.
6. Analyse behaviour
7. Relationship with different policies
8. Develop strategies
9. Plan and implement strategies including intended outcomes
10. Monitor and evaluate the performance of the strategies against the plan

These can each be considered a little further as follows:



### *1. Identify the aims of taxation*

A major function of income tax is, of course, to raise revenue it is also used to support a range of government economic and social policies. This includes the redistribution of income as well as encouraging some activities and discouraging others. The relative importance of these different aims should be considered.

### *2. Identify different methods of achieving the aims*

Income tax might be the best way of achieving the objectives but it may not. Tax expenditure describes the method of conferring some fiscal advantage on a particular group or particular activity by reducing tax liability rather than a direct tax subsidy. This might be wholly unsuitable for some purposes – for example redistributing income – since the benefit depends on a person's marginal rate of tax. Those subject to the highest rate of tax will receive the greatest individual benefit from an income tax concession and someone too poor to pay income tax will not receive any benefit at all. Tax expenditures complicate the tax system and may introduce perverse incentives to those not intended to benefit from them. Aaron and Galper (1985) argue that using taxation to promote worthy causes is usually unfair and inefficient. The original aims might be better achieved by the use of non-tax methods or possibly some combination of tax and non-tax methods.

### *3. Analyse in terms of the economic criteria.*

The main economic criteria that may be used to analyse different reforms are efficiency, incentives, equity, incidence and macroeconomic considerations. These are described at much greater length elsewhere (James and Nobes, 2006) but basically the efficiency question is how a tax might affect the efficiency of the economy through effects on the allocation of resources and also the extent and nature of compliance and administrative costs. Incentives are part of this analysis but sufficiently important to justify a separate examination of the likely effects on the willingness to work, save and invest. Equity issues are particularly important since taxes that are not considered fair by taxpayers are much more difficult, and sometimes impossible, to operate successfully. The analysis of tax incidence will indicate who is likely to be affected by taxes through changes in prices and other economic variables. A tax on one good or service might increase its price and reduce demand and this will cause changes in the pattern of consumption which will affect the demand and prices of other goods and services, even if they are not subject to this particular tax directly. The inputs to both taxed and untaxed goods and services may also be affected. Tax capitalization is often overlooked but should not be – it describes the effect of the market price of an asset when a tax influences the expected yield of that asset. Finally, macroeconomic considerations might also be important for large changes. A particular reform might have implications for the level of unemployment and inflation.

#### *4. Specify the administrative constraints*

As Richard Bird (1998, p. 183) has pointed out, surprisingly, given the copious writing on tax reform, there is little evidence that the importance of tax administration has been taken seriously enough. Administrative issues can influence the whole nature of a particular tax reform and be the deciding factor in its success or failure. It is often a binding constraint on what can be done. For instance some strategies may not be popular with taxpayers to the extent that they are not viable. There may be legal aspects, including obligations under international arrangements, which should be taken into account. Furthermore, all strategies are subject to overall resource limitations including the staff resources and skills of the revenue agency and it may have changing priorities with respect to the use of these scarce resources.

#### *5. Identify different risks*

As Owens (2006, p. 160) points out, with a constantly changing tax environment, it is dangerous to assume that the future will just be a continuation of the past. To establish the areas of significant risk a multilevel approach is needed. At the top level, an assessment is needed of the tax environment and relevant aspects. James (1999) used a strategic management approach for assessing the political, economic, social and technological factors that affect the tax environment and international tax trends and such an approach can be used to identify areas of risk and changes to risk.

Tax competition between countries to attract and keep investment and skilled labour is likely to intensify. The more internationally mobile capital and labour become the more difficult it may be to maintain tax structures that diverge sufficiently from those in other countries to affect such economic flows. A further risk might be an increase in protectionism as some countries try to avoid international competition and this could have damaging effects on world prosperity in general and certain countries and industries in particular. Other factors include a general trend for *per capita* income to rise together with an increasing variety and complexity of financial instruments and demographic changes such as ageing populations – all of which have a number of implications for strategies for tax reform.

The tax environment will also be constantly changing. For instance, Ackerman and Altshuler (2006), in examining how economic and political constraints affect tax policy, found they presented different challenges during the time of the President's Advisory Panel on Federal Income Reform than they had during the tax reform discussions that led to TRA86.

#### *6. Analyse behaviour*

It is important to take account of likely behaviour with respect to taxation and a great deal of work has been done in this area as indicated in Section 3 above. Such behavioral factors can mean, for example, that some taxes are relatively acceptable and therefore

relatively easy to administer while others encounter much greater taxpayer resistance of various sorts and are therefore more difficult to operate successfully.

### *7. Relationship with different policies*

The next step is to take account of the relationship of the tax system to broader government economic and social policies. It might be that different policies are not always compatible and there may be, for instance, a trade-off between the need to raise revenue and the need to keep tax rates low to promote economic incentives. It is often not possible to reform taxation without changing other aspects of government activity as well.

### *8. Develop strategies*

Given the different aspects of the subject, strategies should be both comprehensive enough to address general issues and sufficiently flexible to focus on areas of particular concern. The strategies should take account of the areas of highest priority and those where there is the highest probability of success.

### *9. Plan and implement strategies including intended outcomes*

There are several general considerations involved in planning and implementing strategies. As indicated above, one is to ensure that the planning in this area is consistent with the overall activities of the revenue agency and that resources are used in an efficient and effective way. It is important to gain the support of stakeholders and this can be done in a number of ways such as involving them in the planning stage and providing explanations with respect to the intended strategy. It is important the plan should include intended outcomes and a mechanism for monitoring and evaluating the strategies. Where possible the relevant variables should be quantifiable but not everything in this area can be measured so qualitative feedback should also be sought. Finally there must be provision for modifying the strategies in the light of their performance in practice as well as to take account of changing circumstances.

### *10. Monitor and evaluate the performance of the strategies against the plan*

Monitoring and evaluating performance, of course, is not always an easy task. However a number of issues are worth mentioning. Given the complexity of the tax administration process, one single indicator is unlikely to be sufficient to monitor the whole situation. Observing the trends in particular outcomes is a useful exercise but care should also be taken to continue to monitor the

changing situation with regard to the tax environment and practice, particularly taxpayer behaviour. Over time different issues may well change in their importance with respect to the overall strategy and new ones might emerge.

The final stage in this process is to use the results of the monitoring and evaluation of performance to feed back into the continuous development of the most appropriate tax strategies.

## **7. A Proposal for Promoting a Strategic Approach to Tax Reform**

The main economic policies available to governments are monetary policy – associated with interest rates and the money supply - and fiscal policy – taxation and public expenditure. With respect to monetary policy, in the USA, the UK, Australia and New Zealand, the reserve bank has a degree of operational independence, most notably in setting interest rates.

Fiscal policy in many ways is so bound up in almost every conceivable way with the operation of the economy and government influence over it that it is hard to imagine any government passing operational control to an independent body in the way it has been with monetary policy. However, perhaps it might be worth exploring the possibility that an independent contribution to the development of tax strategies could be advantageous. Currently most of the input in this area comes from miscellaneous contributions from both the public and private sectors and *ad hoc* enquiries. If an appropriate body were charged with the responsibility of collecting the information necessary to develop strategies on a permanent basis, it could offer systematic guidance to the process of reforming taxation over time. An obvious example is in observing how inflation and economic growth is affecting the tax structure. Such a body could also take account of other factors such as economic growth and economic and social change more generally, both nationally and internationally. There may even be scope for some limited aspects of the tax system to be changed, in much the way interest rates are for monetary policy, without the need for direct government involvement. An example is the way some countries have linked tax thresholds to inflation.

There would be no shortage of work for such a body. The development and implementation of the ten stages outlined above would mean that much useful work could be done. Particular aspects include attempts at weighing up the importance of different aspects taxation. For example, how far should the tax system be tailored to individual circumstances and how far should simplicity be sought and complexity be limited. Clearly answers to questions such as this may change over time and be different in different contexts. Another substantial task is analysing the economic, social, political and technological environment in an international context (James, 1999) and the implications for the successful operation of the tax system.

What seems very clear is that the present situation, in which pressure for change has to build up over time before change happens, is not the optimal arrangement. In addition to anticipating necessary change, such an independent authority could also assess *ad hoc* proposals systematically for suitability for implementation. It has been suggested that the political process might generate tax changes that are associated with short-term popularity rather than long stability – for example, there have been many contributions to the literature on the political-business cycle since Kalecki's (1943). A recent study by Shi and Svensson (2006) and based on a large panel data set consisting of 85 countries over a 21 year period found clear evidence of political budget cycles. With elections taking place at least once every five years in the UK, four years in the USA and once every three years in Australia, an independent authority might be a powerful and stable force for rational decision-making with respect to tax reform.

## **8. Conclusions**

Taking too narrow approach to tax research, in particular failing to take account of behavioral effects on the part of all those affected by the tax system, can lead to inadequate conclusions as illustrated by the examples of tax compliance and tax simplification. It may be that individuals are limited in the amount of information they can handle and process about the wider environment. This might also explain why much tax reform takes place on an incremental basis – indeed an incremental approach might be the best strategy.

Tax reform often takes place on an *ad hoc* basis and the results are sometimes less than satisfactory. This is not surprising given the range of different objectives in government economic and social policy and that these objectives are subject to changes in emphasis, if not direction. In addition, the economic, social, political and technical environment in which taxes have to operate is also changing constantly. It is therefore suggested that a more systematic and strategic approach to tax reform be developed. It is also proposed that a permanent arrangement might be developed whereby the relevant changes in objectives and the tax environment are monitored and assessed together with appropriate changes to the tax system. In this way reform does not have to wait until sufficient political pressure builds up finally to force change. It is also a safeguard against the introduction of unsuitable proposals.

By taking account of the wider situation, such an approach might also improve the applicability of tax research more generally.

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