

# Chapter 2


## Fiscal Feelings: Behavioral and Neuroeconomic Insights on Tax Compliance

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### **ABSTRACT**

*Tax compliance is a behavior which is not driven only by the threats of penalties and punishments, but one which tends to be influenced by the economic and societal factors in the taxpayer's environment as well as the taxpayer's own psychology. To understand any human behavior, an interdisciplinary approach is preferred as behavior is acknowledged to be the result of the complex interaction of internal aspects of being human like emotions, cognitive processes along with factors from the external environment like social norms and uncertainty. This chapter aims to provide a comprehensive and interdisciplinary explanation of tax compliance behavior based on the theories grounded in behavioral economics and which encompass the influence of emotions, cognitive biases, social preferences and neuroscience. The empirical evidence from behavioral and neuroeconomic research discussed provides a more nuanced and comprehensive understanding of a taxpayer's decision making process and provides examples that can be used by tax administrations in any country to improve tax compliance behavior.*

### **INTRODUCTION**

Successful collection of tax revenue depends on taxpayers' willingness to cooperate with tax authorities and comply with tax rules. Some economics models emphasize that taxpayers make strategic, financially motivated compliance decisions because they are rational. We believe this argument assumes a narrow view of human behavior. Complex tax codes are hard for lay people to understand and comply with. Behavioral economics assumes tax payers are boundedly rational and use the dual process model (Kahneman, 2011) while making decisions. They involuntarily use heuristics which are decision short-

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cuts constructed by automatic, cognitive, psychological processes which include but are not limited to emotions, memory, associative reasoning and reference dependence. The automatic tendency to use heuristic-based decision making has resulted in deviations from what neo classical theories predict for behavior in the real world (Thaler, 1990; Tversky & Thaler, 1990; Rabin & Thaler, 2001). Departures from rationality emerge both in judgments (beliefs) and choices (Ritsatos, 2014; Hashimzade et al., 2012) and are captured in the prospect theory of decision making under risk introduced by Kahneman and Tversky (1979). This field combines insights from economics and psychology providing a better explanation of behavioral puzzles like the tax compliance puzzle - *the effects of audits on voluntary compliance rates*. Existing literature on tax compliance highlights the significance of non-economic factors such as attitudes toward taxes, personal, social and national norms, perceived fairness (Dumre & Shrestha, 2023; James, 2016; Bornman, 2015; Engida & Baisa, 2014; Bărbuță-Mișu, 2011) trust (Faizal et al., 2017; Bornman 2015) and positive emotional experiences with tax authorities (Enachescu et al., 2019) in tax compliance behavior. Alm and Torgler (2006) and Cummings et al. (2009) showed that tax morale is also an important factor in reducing tax evasion and increasing voluntary tax compliance. Attempts to understand any human behavior require an interdisciplinary approach as behavior is the result of the complex interaction of internal aspects of being human like emotions, cognitive processes combined with factors from the external environment like social norms and uncertainty (Macintyre et al., 2023; Barrett, 2017).

In this chapter, we propose to address the question of how neural mechanisms shape tax compliance behavior across taxpayer profiles based on insights from neuroeconomic studies in order to enhance the behavioral perspective on voluntary tax compliance. The role of emotions in prediction and decision making is highlighted in the discussion to add a robust scientific dimension to deviation from rational theory. Neuroeconomics methods combine behavioral experiments with neuroimaging techniques to record and investigate the physiological and neural underpinnings of concepts described in behavioral economics literature. It aims to provide a biologically-based account of human behavior that can be applied in social sciences (Rangel et al., 2008). A neuroscientific understanding of voluntary tax compliance behavior can contribute to shaping policies and systems in an advantageous and cost-effective manner (Chorvat, 2007).

Neuroscience has provided valuable insights for the field of behavioral economics by reshaping prevailing psychological theories that inform economic models. Advances in neuroscience have facilitated the direct measurement of brain activity, enabling the study of thoughts, feelings, and cognitive processes. Techniques such as brain imaging allow researchers to infer the mechanisms underlying mental states and gain a strong scientific foundation to challenge established assumptions regarding the relationship between the mind and human behavior. Neuroscience highlights two critical limitations of the neoclassical approach. First, much of human behavior is driven by “automatic” cognitive processes, which operate faster than conscious deliberation and often occur without awareness or intentional effort (Bargh & Chartrand 1999). These automatic processes evolved to address problems of evolutionary significance such as survival and do not necessarily conform to the normative axioms of logical inference and rational choice. Second, human behavior is profoundly influenced by emotional and affective systems (LeDoux, 1996) which are essential for survival and daily functioning. Emotional experiences and subjective perceptions should be taken into consideration when designing policies to promote compliance.

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